

CRANFIELD UNIVERSITY

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THE FACTORS AFFECTING THE AUDITOR SELECTION DECISIONS  
OF FTSE 350 COMPANIES IN COMPETITIVE TENDERS

SCHOOL OF MANAGEMENT

PhD THESIS

Academic year 2014-2015

Supervisor: Professor Lynette Ryals

April 2015

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## **ABSTRACT**

Auditing provides an important role supporting the function of financial markets where information asymmetry exists between shareholders and management. The audit market for the largest publicly listed UK companies, those within the FTSE 350, has however come under scrutiny following a number of financial scandals and, driven both by quality and competition concerns as the largest audit firms, the “Big 4” are dominant. Auditor tenure and long periods without competitive tenders have been recurrent concerns and yet how companies select their auditors is under researched.

This study examines the influences on the complex decision process underlying auditor selection in FTSE 350 companies during an important period, namely that between the acquisition of Arthur Andersen by Deloitte in August 2002 and the introduction of the September 2012 UK Corporate Governance Code by the Financial Reporting Council.

Based on a social constructionist philosophical perspective and adopting a grounded approach, the study covers 60 auditor selection decisions (over half of those identified in the research period) and includes in depth interviews over a period of two years with those who had recently been involved in a FTSE 350 auditor selection process; both from the buy-side and the sales-side.

A conceptual model is developed which illustrates five factor groups that this research identified as influencing auditor selection in typically comprehensive proposal processes. These were: Relationships at the start of the proposal process, Service design, Capabilities and competences of the bidding

firms, Behavioural influences during the proposal process and Final decision making. It also identifies interrelationships between these factor groups.

These results are important because they inform theory and practice at a time when auditor change is becoming a statutory requirement. The study also has implications for other complex purchases of intangible services, particularly other professional services, and potentially for complex decision situations more generally.

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## **ACKNOWLEDGEMENTS**

The PhD experience is the culmination of 30 years of study for me including previous academic and professional qualifications. After all this time it seems never more true to me that the more one studies, the less one seems to know.

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# CHAPTER ONE

## AUDITOR SELECTION: THE REGULATORY AND PRACTICE BACKGROUND

### 1.0. Introduction

This study explores the auditor selection decision during an important period of evolution of audit and regulation in financial markets following a research approach which has been designed to answer the research question:

*What are the factors affecting the auditor selection decisions of FTSE 350 companies?*

This first chapter explores the context of the study. The next chapter then sets out the literature review which considers the auditor selection decision including supplier selection literature and aspects of decision theory and other relevant literature.

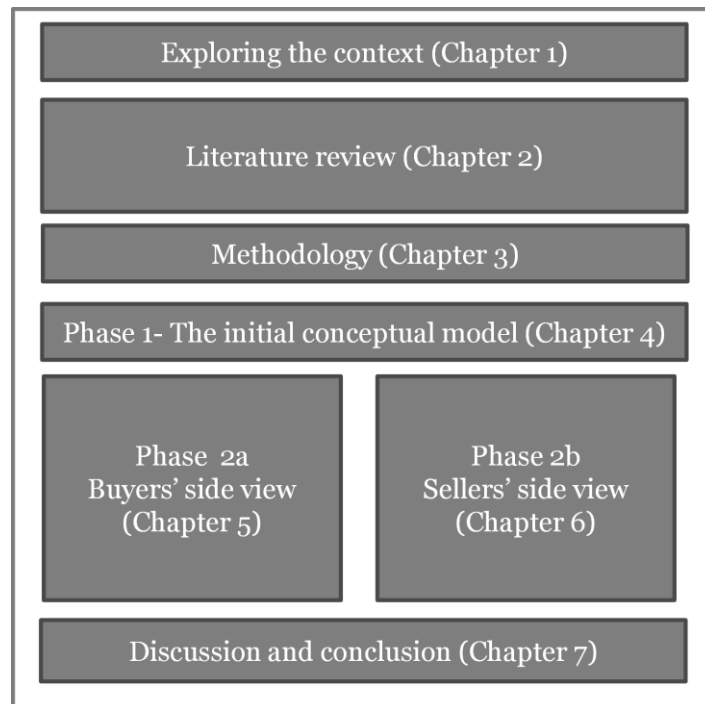


Figure 1: The three phases of the research within the whole approach

After setting out the research methodology in Chapter 3, the findings of the three phases of the research are set out in the next three chapters prior to Discussion and conclusion.

### **1.1. The audit market and regulatory context**

This first chapter summarises the practical and regulatory background relevant to the auditor selection decision. Those making auditor selection decisions do so within a regulatory, legal, market and professional framework which it is important to recognise as an influence and a contextual background.

The role and importance of auditing to financial markets is considered first and then the more recent historical context; including the events which have given rise to a substantial change in the auditing profession and how the regulatory regime has evolved during the period covered by the study.

Market concentration and its influence on auditor choice is then considered including the findings of a number of market investigations which took place before and during the period of study. The regulatory investigations and developments and those relating to competition are considered separately in Sections 1.2 and 1.3.

This chapter also considers three other influences relevant to auditor selection namely: the presence of cross directorships and networks across FTSE 350 company boards, the frequency of auditor tenders and longevity of auditor appointments and the nature of audit tenders once underway.

This chapter therefore provides the essential contextual background to the audit market position and for the current study.



## **1.2. Auditor appointment a high profile decision**

The audit of public companies has come under closer and closer scrutiny in recent years prompted at least in part by a series of financial scandals; most recently the financial crisis which followed the collapse of Lehman Brothers in 2008. Although the audit continues to play an important role in supporting confidence in financial markets, the regulatory regime has evolved considerably and those making auditor selection decisions have increasingly been doing so in a much tighter regulatory environment. This section discusses some of the events that have brought audit into public focus, why this is important because of the special nature of audit and how the regulatory environment has evolved as a backdrop to audit and auditor selection.

### **1.2.1. The impact of financial scandals**

The global banking and financial crisis, which came to a head with the collapse of Lehman Brothers in 2008, focussed attention on corporate governance in the UK's largest listed companies. But in reality this latest market crisis followed a series of scandals affecting "UK plc". These have included the widely publicised collapses of BCCI, Maxwell Corporation and Polly Peck in the early 1990s and Barings in 1995, Enron in 2001 (and the subsequent collapse of Arthur Andersen in 2002) and the administration of Parmalat in 2003. These events have been significant not only because of the financial losses that shareholders, creditors, affected staff and others have incurred, but also because they represented failures in corporate governance;

thereby having a damaging, and in some cases highly damaging, effect on confidence in financial markets and their effective operation.

Whilst most of these events involved fraud and have generally been agreed to represent failures in financial controls and corporate governance more generally (including the roles and responsibilities of directors, the conduct and constitution of Boards, the maintenance of adequate internal accounting control procedures and the information reported to shareholders) they have inevitably also brought into question the quality of statutory external audit.

Audit quality has been defined as “the market assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach” (DeAngelo, 1981, page 186). With problems with the financial markets came a perception for some at least that there were failings in audit quality and therefore something wrong with the scrutiny and selection affecting auditors. For problems not to have been brought to light earlier, some argued that by inference either auditors had not discovered them (which could *prima facie* amount to shortfalls with the quality of work they were undertaking), or they were in some way complicit in not bringing them to the attention of shareholders (potentially implying over familiarity as a result of long periods of tenure). These financial problems each appeared to be a surprise, at least to some extent and especially to those outside the companies concerned. Questions have therefore arisen as to why problems were not identified and/or if identified not reported.

These questions are fundamental to the auditing profession because the statutory audit has always been (and remains) a critical part of the effective overall operation of financial markets, particularly given the information asymmetry which exists between managers of public companies and their shareholders. This is discussed next.

### **1.2.2. Information asymmetry and the important role of the auditor**

With the separation of ownership from the management of public companies and the resulting agency position comes information asymmetry (see for example, Adams et al., 2005). An agency position results from directors of public companies managing a business on behalf of shareholders who in many cases are not involved in the day to day running of that business. Information asymmetry follows because the information publicly available to shareholders is significantly less than that available to management who are charged with the day to day operation of the business. Management who have day to day oversight of the business typically manage numerous amounts of data. This includes detailed day to day information relating to the business, its progress and performance, accounting controls and weaknesses etc. which it would be impractical and/or undesirable to make public for a number of reasons, not least competitive commercial advantage. In a world where detailed financial management information is not generally put in the public domain should detailed financial information about any individual company be put into that public domain, competitors would be able to more effectively refine their

strategies and approaches so as to compete more successfully with the company concerned.

The rights of shareholders, designed to protect them in this agency relationship and recognising information asymmetry, are well developed and the role of the auditor is a critical element within them.

The auditor is in normal circumstances formally appointed each year by shareholders at an annual general meeting by a shareholder vote on a resolution containing a recommendation by the relevant company's Board. As part of their responsibilities, the auditor formally reports to shareholders each year on the truth and fairness of the financial statements presented to them by the relevant company (and on certain other matters see below) and their opinion is included in company's annual report. This opinion results from an independent examination of the company's accounting records conducted in accordance with applicable law and regulation and in accordance with auditing standards issued by an independent standard setting body. The audit opinion provides an important input into helping to manage the uncertainty associated with information asymmetry. By providing an independent examination of the financial statements and the expression of an opinion on their truth and fairness, the audit plays an important part in protecting the interests of shareholders (NB this area has developed recently following the issuance of a new auditing standard ISA 700 in June 2013 (FRC, 2013) expanding the information disclosed in the auditors' report). And although there has been some wider misunderstanding about what an auditor was actually required to do (the so called "expectations gap" where users of accounts think the auditor

has greater responsibility to do more work than actually required by statute and regulation (see for example ICAEW (2006)) the auditor had, and continues to have, unique rights and responsibilities which are codified in company law to enable them to discharge their important role.

Auditor rights and responsibilities are longstanding and were reconfirmed most recently in the Companies Act 2006, which reaffirms: “a right of access at all times to the company’s books, accounts and vouchers (in whatever form they are held)” (Section 499 (1) a) and wide ranging rights to require those related to the company and its financial statements to “provide him with such information or explanations as he thinks necessary for the performance of his duties as auditor” (Section 499 (1) b). These rights provide the auditor with unparalleled access to company information including share price sensitive information and rights and responsibilities to report issues and errors to management and, where important, to the audit committee in a way that is transparent and fair (NB in certain limited cases auditors also have responsibilities to report to regulators and the police). These rights and responsibilities establish accompanying levels of trust to behave reasonably, to maintain confidentiality and highlight issues appropriately. Audits can be led only by professionally qualified and registered auditors who are required to comply with the rules of the accounting profession, especially with regard to integrity and objectivity, and to be independent of the company both individually and as a firm. The ethical responsibilities and requirements which apply to both individuals and practising audit firms are set out in the Code of Ethics issued by the ICAEW (see <http://www.icaew.com>).

Given information asymmetry, independence is important to companies and their auditors are very alert to the threats involved. These include “Self Interest Threats” (where “the audit firm or a member of the audit team could benefit from a financial interest in, or other self-interest conflict with, an audit client”) “Self Review Threat” (where “the audit firm, or an individual audit team member, is put in a position of reviewing subject matter for which that individual or their firm was previously responsible”), “Familiarity Threat”(where, “by virtue of a close relationship with an audit client, its directors, officers or employees, an audit firm or a member of the audit team becomes too sympathetic to the client’s interests”), “Advocacy Threat” (where an auditor finds him/herself in a position of advocate either for or against a client in an adversarial situation or takes a strong and proactive position in support of a client) and “Intimidation Threat (where an auditor is at risk of being intimidated by, for example, a dominant company director) (See ICAEW, 2003, pages 5-6).

In addition to these special rights and responsibilities the audit has traditionally also been bound by a particular contractual liability position. Unlike most other contracts, the auditor is unable to limit his/her liability. This is important because if financial loss can be proven to have arisen as a result of negligence by the auditor, the damages that can be claimed from the auditor can be substantial, including putting the personal assets of the individual audit partner signing the published financial statements at risk. The major audit firms have substantial financial resources and the market is very aware of this position (See Section 1.3). The auditor selection decision is therefore also highly

important for the audit firms, as in accepting appointment they are taking on considerable risks which could have consequences both for the continuing existence of their firms and the financial position of individual partners.

Lastly under rights and responsibilities, as McMeeking (2009, page 7) notes, “The market for audit services is unique because it is a statutory requirement for companies to have an audit but it is provided by the private sector”. The obligation to have an audit each year is therefore imposed upon companies (which means that unlike most other consulting assignments the option not to proceed is not available) and, because the auditor is required to be independent, companies cannot conduct their audit themselves (although they can put in place systems and controls which auditors may test and rely on in coming to their opinion).

The critical and unique role of the auditor therefore further underlines the importance of auditor selection.

### **1.2.3. Regulatory reviews and their impact on auditor selection**

The role and function of audit was comprehensively reviewed as part of a general review of corporate governance in 1991. The setting up of the UK Committee on the Financial Aspects of Corporate Governance led by Sir Adrian Cadbury was a direct response to a perceived need to improve the quality of corporate governance generally and the Committee included representatives of industry, regulators, the stock exchange, shareholders and the legal and accounting professions. Its review included widespread consultation with interested parties. The Committee’s findings and recommendations were issued

in 1992 within what has become widely known as the Cadbury Report (Cadbury Report, 1992).

The Cadbury Report was aimed at all listed companies in the UK and included a wide ranging number of observations and recommendations covering the effectiveness and constitution of boards of directors, the role of non-executive directors and audit committees, the operation of internal control and internal audit, financial reporting and the consistent application of accounting standards and the relationship of companies with their shareholders. Importantly the report made a number of observations and produced recommendations aimed at increasing the effectiveness and value of the audit. Whilst recognising the importance of the audit as “one of the cornerstones of corporate governance” (Cadbury Report, 1992, paragraph 5.1), the report also recommended the extension of auditors’ responsibilities including reporting on directors’ assessments of the effectiveness of companies’ systems of internal control and their assessment of going concern. Significantly, although stopping short of recommending the rotation of audit firms, the report recommended the periodic change of audit partners “to bring a fresh approach to the audit” (Cadbury Report, 1992, paragraph 5.12). This was important as it set the precedent that changing audit partners represented good corporate governance. Hitherto, audit partners had often had individual professional relationships with their audit clients which often persisted for many years. As with many professions value was placed on trust, knowledge and professional integrity which facilitated understanding and therefore appropriate judgements on issues as they arose (NB accountants had previously been referred to as “the



priesthood of industry” (Sampson, 1962)). Once implemented, the Cadbury Report recommendation meant that there would inevitably be a need to break relationships and rebuild new ones with individuals albeit mainly within the same overall inter-organisational audit arrangements. Individual long term relationships in audit would be precluded, changing the nature of the audit relationship and consequently auditor selection.

The Cadbury Report formed the basis of a new UK Corporate Governance Code in 1992 and a requirement was added to the Listing Rules of the London Stock Exchange that companies should report whether they had followed the recommendations or, if not, explain why they had not done so (this is known as ‘comply or explain’). The Cadbury Report was widely regarded as the first and most comprehensive guidance on corporate governance anywhere. It also set the precedent for a regulatory framework with a number of corporate governance guidance updates following; each refining the regulatory framework and the nature of the audit relationship. These included the Committee on Corporate Governance or Hampel Report (ICAEW Committee on Corporate Governance, 1998) and the Turnbull Report (Internal Control: Guidance for Directors on the Combined Code – ICAEW, 1999).

In 2002, following scandals at a number of US companies including Tyco International, Worldcom and notably Enron (which resulted in the collapse of Arthur Andersen, subsequently uncovering a large number of shortcomings in the conduct of the Houston office of that firm), recognition of audit and the critical role it played in governance again came to the fore and the Sarbanes Oxley Act was passed in the US (See <http://www.sarbanesoxley>). This Act,

which also applied to UK companies listed in the US, introduced far reaching new provisions on corporate governance and auditor independence, including strict rules as to which non-audit services could be provided by auditors to their clients. The Act also introduced the Public Company Accounting Oversight Board responsible for regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies.

Although the UK had experienced no similar recent collapse at that time and, in particular, no similar misconduct by any UK audit firm, the loss of confidence caused by events emanating in the US led the UK Government to instigate a review under the Coordinating Group on Audit and Accounting Issues. This review again focussed on listed companies and considered a number of aspects pertinent to their audit including auditor independence, the role of the audit committee, transparency and monitoring of audit firms and financial reporting. The Group's final report was issued in January 2003. It too found against mandatory auditor rotation and mandatory tendering. Although the Group "could see some attractions for competition in such a requirement [for mandatory tendering]" it concluded that such a step would "cut across the enhanced role we see for the Audit Committee" (Co-ordinating Group on Audit and Accounting Issues, Final Report, 2003, page 27). The Group did however support new rules on audit partner tenure introduced by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants in Scotland which, following the Cadbury Report, required rotation of lead audit partners from the audit of a company of which they were the lead audit partner every five years, and certain other partners and staff every seven

years. The report also supported increased responsibilities for audit committees in overseeing auditor appointment, tighter scrutiny of non-audit services provided by auditors and the introduction of an independent monitoring body for audits.

The Group also commissioned a separate report under the chairmanship of Sir Robert Smith to provide guidance to companies on the effective operation of audit committees. The Smith Report (Audit Committees Combined Code Guidance, 2003) was issued and supported a strong role for audit committees in overseeing governance in public companies. The report also specifically supported an important role for audit committees in relation to audit; in particular: “to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor following appointment by the shareholders in general meeting; to monitor and review the external auditor’s independence, objectivity and effectiveness; to develop and implement policy on the engagement of the external auditor to supply non-audit services” (Page 6). The recommendations of the Smith Report along with those of a report on the effectiveness of non-executive directors following a review by Sir Derek Higgs (Review of the role and effectiveness of non-executive directors, 2003) were included in the UK Combined Code on Corporate Governance of 2003. The emphasis being placed on the role of the audit committee in auditor appointment can be compared with the historically greater importance in practice of the finance director in that decision (NB In addition to practical evidence previous research had also highlighted finance directors as most

influential in auditor selection in the past although their influence reduced where audit committees were present (Beattie and Fearnley, 1998a). The new code also focussed yet more attention on audit evaluation and effectiveness.

The events surrounding the US scandals of the early 2000's also had a profound effect on the businesses of the major audit firms and their relationships with their major clients. Hitherto it had been common practice for major organisations (recognising the knowledge of them that their auditors possessed) to employ their external auditor to perform other services such as providing tax advice and consulting services. The dominant emerging view however became that these other services represented a perceived threat to auditor independence and had to be much more strictly controlled. By the end of 2002 three of the Big 4 had sold their consulting practices. Prior to the Arthur Andersen collapse at the end of 2001, the then FTSE 100 companies were paying almost three times as much in non-audit fees to their auditors as they were in audit fees and the next 250 companies twice as much. In 2004 (the first full year following the post Enron regulatory changes) these ratios had fallen to just over one to one for both the FTSE 100 and FTSE 250. Although the Big 4 would in subsequent years rebuild their consulting, or advisory businesses as they became known, they were now increasingly selling these services to other audit firms' audit clients. The nature of auditor selection had therefore fundamentally changed. Whilst those choosing auditors might previously have been looking for a supplier of a range of professional service solutions, the auditor selection decision was now more narrowly defined with a greater focus on independence. There was now much greater concern about perceived threats

to independence that might occur through auditors providing non-audit services, at least beyond those services which were related to the audit.

Whereas before the collapse of Arthur Andersen the audit had been the hub of a multidisciplinary relationship which facilitated the on-sell of other services, it now became much more distinct and, through the restrictions based on non-audit services, actually now heavily restricted on-sell. This was both formal, through the introduction of company policies governing service provision by statutory auditors, and in practice, because the requirements for approval of services by audit committees introduced an additional administrative step in the procurement process which management could choose to avoid by selecting professional services providers who were not their auditors. These changes led to different choices for companies and their auditors. Whilst companies broadened their professional service provider options away from their auditors and consequentially narrowed their relationships with their auditors, audit firms were faced with having to respond to those decisions; tailoring their approaches and the focus of their relationship management activities.

In 2004 the post Enron regulatory environment advanced further when the Professional Oversight Board (“POB”) was set up in the United Kingdom as part of the reformed Financial Reporting Council. This introduced statutory independent oversight over the regulation of auditors and reviewed directly, on a sample basis through the Audit Inspection Unit (AIU) now Audit Quality Review Team (AQRT), the quality of the audits of listed and other major public interest entities. The AQRT reports publicly every year on the findings of its

inspections. For the first time the audit quality of firms was being directly examined by an independent regulator outside the accounting profession and in overall terms being put in the public domain thereby providing signals to the market on the comparative quality of the firms (albeit based on small samples).

A stream of law and guidance has followed based on these foundations, including a revised UK Corporate Governance Code in September 2012 and subsequently changes to European Community Law published in July 2014 (European Parliament, 2014). A summary of these developments which post-dated the research period for this study and their potential practical implications for auditor selection is set out in Chapter 7.

The growth in regulation and the power and influence of regulators within the auditing profession has therefore been unprecedented within the past 20 years. Until the financial scandals of the late 1980's and early 1990's auditing had been largely self-regulated by the profession's own institutes with a focus on competent and ethical behaviour by their members. Within 20 years, although these professional and ethical standards still apply, a comprehensive regulatory regime has emerged, not only reliant on monitoring people and the processes and procedures of their firms, but independently examining, on a sample basis, the detailed conduct of audits. As noted above, the period has also seen the establishment and increasing influence of audit committees on auditor appointment. The auditor selection decision has also therefore changed, and most fundamentally more recently. Before 2002, as noted above, auditor selection decisions were about wide ranging relationships and normally led by financial management especially the finance director. Since then they have been

about much more narrowly defined relationships and with much greater influence expected from audit committees.

In summary, auditor selection has come under ever closer scrutiny and those selecting auditors do so knowing both that it is an important decision and that that decision is both subject to regulatory review and public; with the potential to be of especially high public profile both for companies and individual directors should anything go wrong. With the direction of regulation all listed (and some other) companies will now have to consider an audit tender and greater understanding of the audit tender decision will help inform that process.

### **1.3. Auditor selection and auditor choice. Concentration and competition in the FTSE 350 audit market**

The previous section considered the evolution and related impact of the regulatory environment surrounding auditor selection following a number of high profile financial scandals. In addition to the regulatory scrutiny surrounding auditor selection and appointment, to understand the context for that decision, it is important to consider the nature of the market and in particular, the extent of its concentration into four major firms. This issue is therefore discussed next.

Ironically, until 1984, there had been strict regulations enforced by the profession in the UK against solicitation of other auditors' clients including for example, a bar on advertising for audit services. Competing for new business had been considered unprofessional by many and even a threat to the

independence of the auditor. This supported and underpinned the long standing audit relationships referred to above.

The auditing profession had however been consolidating for many years as individual firms grew and merged, principally to meet the needs of their clients; both in terms of depth of resources and global reach. Following the removal of professional restrictions to competition amongst auditors and a period of supply side pressure dating back to the 1989 recession (see for example Beattie and Fearnley, 1998b) this consolidation culminated in three major mergers. The Big 8 became the Big 6 in when Ernst & Whinney merged with Arthur Young to form Ernst & Young in June 1989, and Deloitte, Haskins & Sells merged with Coopers and Lybrand in in the UK in January 1990 (Deloitte merged with Touche Ross in most territories around the world). The last major merger; that of Price Waterhouse and Coopers & Lybrand to create PricewaterhouseCoopers in 1998, was approved following a lengthy competition authority review at the European Commission.

When Arthur Andersen's UK business was absorbed by Deloitte and Touche (now Deloitte) in August 2002 (having been taken over elsewhere in the world mainly by Ernst & Young), the current Big 4 was created. These four firms have since dominated auditing in the UK (and globally). Their fee income dwarfed other firms as highlighted in Table 1 below which shows the total income and audit fee income of the Big 4 firms in the UK compared with those of the then next four (BDO Stoy Hayward, Baker Tilly, Grant Thornton and PKF) shortly after the collapse of Arthur Andersen in 2002.



Firm	Year end	Total fee income £m	Audit fee income £m
PricewaterhouseCoopers	30 June 2003	1,505	453
KPMG	31 September 2003	1,008	291
Deloitte	31 May 2003	1,188	260
Ernst & Young	30 June 2003	812	226
<b>Big 4</b>		<b>4513</b>	<b>1230</b>
BDO Stoy Hayward	30 June 2003	169	82
Baker Tilly	31 March 2003	150	59
Grant Thornton	30 June 2003	216	58
PKF	31 March 2003	107	46
<b>Next 4</b>		<b>642</b>	<b>245</b>

Table 1: The audit market shares of major UK audit firms following the collapse of Arthur Andersen in 2002  
Source: Financial Reporting Council; Professional Oversight Board for Accountancy; Key facts and Trends in the Accountancy Profession, February 2005

As the table shows, the total combined fee income of the Big 4 was approximately seven times that of the next four largest accountancy firms in the UK and over five times their audit fee income. Importantly, each of the Big 4 firms, although separate legal entities in the UK, were also part of very extensive established global networks with substantial resources. These networks are important because in recent years companies have generally chosen to have the same auditor across all of their operations. The existence of global networks means that these firms could not only provide audit services in a number of countries but also provide a more consistent service across those countries (Oxera, 2006).

The newly created Big 4 were also auditors of 97% of all the companies in the FTSE 350 in the third quarter of 2002 including all of the UK's top 100 companies (based on appointments as disclosed in annual reports and announcements of the FTSE 350 companies at that date) and although there would be changes within the Big 4, their domination of this market has continued ever since. At the end of the third quarter of 2013 the Big 4 were still

auditors of 96% of the FTSE 350, earning over 98% of the some £575 million of audit fees paid by those companies (Source: summary of audit fees as disclosed in the annual reports of FTSE 350 companies).

### **1.3.1. Competition and Choice in the UK audit market.**

#### **The Oxera Study (April 2006)**

The market domination by the Big 4 has attracted further government and regulatory interest. In 2005 the Department of Trade and Industry and FRC commissioned a study of competition in the audit market conducted by Oxera (Oxera, 2006). The study sought views on competition and choice from interested parties using in-depth interviews and a survey of Audit Committee Chairs of listed companies.

As part of their work Oxera considered auditor selection including conducting a survey of Audit Committee Chairs. This was not restricted to the FTSE 350 and included audit committee chairs of companies in the FTSE Small Cap index. Their work nonetheless indicated that reputation was important; in particular the importance to FTSE 350 companies that their auditor was one of the Big 4. This was important, they observed, for example because of the difficulties in accurately assessing the quality of staff and international coverage and was also seen to be important for investors. The other factors considered most important were sector specific expertise, international coverage (where one concern was consistent service, especially across countries with relatively low standards of corporate governance) and technical accounting skill.

The context and purpose of the Oxera study is important. The size and scale of the Big 4 discussed above means that other firms struggle to compete on these factors. In most cases however, and for the same reason, the Big 4 all possess these characteristics and therefore, whilst explaining short listing and market concentration, these factors are unlikely to provide an explanation of auditor selection between the Big 4 which, as Section 1.4.2 below will show has characterised the vast majority of all audit FTSE 350 tenders.

Whilst it wasn't covered in their survey of audit committee chairs, one other factor which was mentioned as important was a good relationship between the audit partner and the audit committee and other members of the Board. This of course could be a differentiator between the Big 4 and this subject is returned to in Chapter 2 where the literature concerning auditor selection is reviewed. It is less clear from the Oxera study how important this might be and whether there may be other potentially differentiating factors between the Big 4.

The Oxera report (Oxera, 2006) argued that there were three elements to audit service: a core compliance element, a value added element and an insurance element (audit being a line of defence against accounting failure and as noted above subject to unlimited liability – see also Bar Yoesef and Livnat, 1984)) and concluded that competition was not working effectively. The report commented on high barriers to entry, both actual and reputational and also noted the very low switching rates of auditors of companies in the listed market. For FTSE 350 companies this was 3% per year between 1995 and 2004. The message was that low switching rates may be indicative of a lack of choice given

the limited number of firms available to meet companies' needs and the cost of transition.

The barriers to entry for firms seeking to operate in the FTSE 350 audit market identified by Oxera (2006) included the need to acquire a credible reputation within FTSE 100 and FTSE 250 companies and their investors, the need for an extensive integrated international network and for substantial resources and experience so as to be able to audit large complex international companies.

The findings of the Oxera study implied that selectors of auditors were effectively choosing from a shortlist of four. In fact there may be less than four where commercial, independence or other issues precluded consideration of one of the Big 4. Given the changing nature of the audit relationship noted above, in many instances the Big 4 are likely to have consulting relationships which would breach independence requirements and therefore preclude them from acting as a company's auditor unless they are discontinued.

### **1.3.2. The Market Participants Report (2007) and the McMeeking Report (2009)**

In part at least in response to the findings of the Oxera Report in 2006 the FRC established the Market Participants Group to advise it on "possible actions that market participants could take to mitigate risks arising from the characteristics of the market for audit services to public interest entities in the UK" (FRC, 2007, page 3). This Group, including public company directors, representatives of major shareholders and of the auditing profession, issued a

report which highlighted a number of reasons why it felt public companies tended to use the largest audit firms “with the strongest brands and reputations” (FRC, 2007, page 5). The reasons they identified included capability, reputational, experiential and relationship factors as their report explains:

“In selecting auditors, audit committees look at the ‘added value’ that firms bring to the company – including accountancy advice and the limitation of the personal and reputational damage of significant accounting misstatements.

- It is more difficult to assess objectively the quality of an audit firm without experience of working with that firm.
- Non-executive directors and others selecting or influencing the selection of auditors are more likely to have experience of working with the Big 4 rather non-Big 4 firms.
- The process of switching auditors can be costly for both companies and auditors” (FRC, 2007, page 5).

The final report of the Markets Participants Group included a number of recommendations to try to broaden market choice beyond the Big 4 and reduce the risk of another major firm leaving the market. It made two recommendations surrounding auditor selection and re-selection. The first of these was to recommend finding ways to improve access by an incoming auditor to information relevant to the audit held by the outgoing auditor. This would reduce the cost and risk of switching. Secondly it encouraged investor groups,

auditors and the FRC to promote good practice for shareholder engagement on auditor appointments and re-appointments.

The Institute of Chartered Accountants of Scotland commissioned follow up research on the Market Participants Group report and their report which was published in 2009 (McMeeking, 2009) highlighted continued concerns over concentration in the large company market and a desire to improve choice. Further recommendations were made but the pre-eminence of the Big 4 continued. Again the debate was focussed on choice and how it could be widened beyond the Big 4 rather than how companies selected their auditor within it.

### **1.3.3. The House of Lords Select Committee (2011) and the Office of Fair Trading Consultation (2011)**

In March 2011, in the aftermath of the financial crisis of 2008, the House of Lords Select Committee on Economic Affairs issued its second report “Auditors: market concentration and their role” following an inquiry into the market for audit of large companies (HMSO, 2011). Their inquiry which involved interested parties from industry, academia and the auditing profession, considered the dominance of the Big 4 and its effects on competition and choice and also whether traditional statutory audit still met the needs of the day. The inquiry also considered whether auditors could have mitigated the effect of the financial crisis by alerting investors to the riskiness of the assets held by banks. Although the inquiry concerned itself with market concentration and concluded that an oligopoly existed in the large firm audit market which was “underpinned

by the fact that large firms are legally obliged to have their financial statements audited” (House of Lords, 2011 page 9), it also questioned audit quality, especially given the fact that the auditors failed to give warning of trouble in the run up to the financial crisis of 2008. Amongst the recommendations which the Committee made was one for a detailed investigation of the audit market by the Office of Fair Trading with a view to an inquiry by the Competition Commission.

During 2011 the Office of Fair Trading (“OFT”) conducted a consultation process of its own and expressed concerns about the highly concentrated market for the audit of large companies with low levels of switching (see also Section 1.4.2 below) and substantial barriers to entry and expansion. It concluded this meant that this market may not be working well for customers. In October 2011 the OFT referred the market for supply of statutory audit services to the Competition Commission (now the Competition and Markets Authority). The Competition Commission reported in 2013 (and subsequently issued new proposals in July 2014 following new European Commission regulations – see below) after the research period of this study and its findings and implications are considered in Chapter 7) but the backdrop of increasing regulatory focus on auditor selection had been developing during the period of the study.

#### **1.3.4. The European Commission**

In addition to a developing regulatory environment in the United Kingdom pressure for regulatory change affecting audit tendering and auditor selection was also growing in Europe. In November 2011 these pressures were highlighted by the issuance by the European Commission of “The Legislative Proposal on

Audit Policy (European Commission, 2011) (often referred to as “The Barnier Report after its author) which proposed mandatory tendering of audits of public interest (listed and some other) companies and mandatory rotation of auditors every six years. As with the Competition Commission the final proposals of the European Commission were issued after the study completion date and will also be returned to in Chapter 7 but again during the study period they were part of an emerging regulatory environment within which those who were selecting auditors were operating.

#### **1.3.5. Conclusion on regulatory influences on auditor selection**

Those making auditor selection decisions face constraints on the choice of firm and for many a Big 4 firm, with its associated network may be the only realistic option. Those making auditor selection decisions over the study period would also have been increasingly aware of competition authority interest in auditor selection and may have been aware of some pressure to consider other firms, even though, for most, their options were in practice restricted to the Big 4. These influences provide further important contextual background to auditor selection.

#### **1.4. Other influences on auditor selection in the FTSE 350**

In the previous two sections, the high profile nature of auditor selection, the evolving regulatory environment and the competitive landscape facing those making auditor selection decisions were discussed. This subsection now considers certain other attributes of the audit market within the FTSE 350 which are other potential influences on auditor selection namely: the linkages



between buyers of audit services, the frequency and outcomes of processes and lastly the nature of auditor selection processes. As will be explained below, each may be an influence on the auditor selection decision.

#### **1.4.1. Auditor selection - cross directorships, a network of buyers and buying influences**

In the previous section the supply side of the FTSE 350 audit market was considered and in particular the impact of concentration within the Big 4. In this section a particular feature of the demand side is examined further and that is the connections between directors of FTSE 350 companies who are making and/or influencing auditor selection decisions.

Chapter 2, which explores the literature concerning decision theory and influences on decision makers, will discuss certain literature as it relates to the importance of relationships, prior experience, and network influences for example through word of mouth. The presence of cross directorships and networks in the FTSE would suggest that auditor selection decisions are likely to be influenced, at least to some extent, in this way.

As explained in Section 1.2.2 above, the auditor appointment decision is formally one for shareholders to approve based on a recommendation from the Board of the company involved. In turn the responsibility for overseeing relationships on behalf of companies rests with the audit committees of those companies. Board members and especially audit committees therefore have specific responsibilities in relation to auditor selection.

There are some 4000 directors of FTSE 350 companies of which some 1100 are members of audit committees (Source; Management Information of one of the Big 4 firms: May 2013). There are also a number of sources of connection between the directors in this group which are now discussed.

One source of connection is caused by appointments that individual directors have on more than one company board. For example over 25% of all audit committee members have directorships at more than one company. In ten cases they have four or more FTSE 350 company directorships (Source: Management Information of one of the Big 4 firms: May 2013). This means that directors are coming into contact with others and are therefore potentially discussing their experiences. These directors may in turn be having those discussions with others who may also have other directorates within the broader FTSE 350 network and so on.

In addition to current experience, directors may also have other experience gained from previous appointments. Directors often move around from company to company and it must be at least possible that some of their relationships sustain. Audit committee members in particular are normally only appointed for a maximum of six to nine years so have to move from time to time between companies as their terms expire; bringing them into contact with more FTSE 350 directors.

Directors also have connections through professional bodies (for example some 500 of the FTSE 350 directors are members of the Institute of Chartered Accountants in England and Wales (Source: Management Information of one of

the Big 4 firms: May 2013).); or other associations, for example the Hundred Group of Finance Directors which brings together those finance directors from mainly FTSE 100 companies.

Directors also have other connections with the Big 4. Some 55% of all Audit Committee Chairs of FTSE 350 are alumni of the Big 4 along with over a quarter of all audit committee members. In addition 57% of all Finance Directors of FTSE 350 are Big 4 alumni (Source: Management Information of one of the Big 4 firms: May 2013). Connections exist with other alumni (either stronger or weaker) and these are actively promoted by the Big 4 firms who each operate alumni programmes including events and publications (Source: Management Information of one of the Big 4 firms: May 2013).

Directors are also brought together by the general marketing and training events offered by the Big 4 firms (and others). For example a number of programmes are run to inform non-executive directors and financial management on latest developments, or simply to promote networking between peers in particular market segments or industry sectors (Source: Management Information of one of the Big 4 firms: May 2013).

In addition the introduction of the requirement for audit partners to rotate off an audit after five years, as referenced above, means connections are broadened. Whereas in the past an audit partner may have had only a small number of longstanding clients during their career, they are now moving between FTSE 350 companies. An increase in audit tendering will potentially amplify this effect by creating a greater number of contacts between auditors

and companies across the FTSE 350 both as a result of the tender processes undertaken and due to the auditor changes that are likely to occur.

In summary therefore those involved in FTSE 350 auditor selection form a highly networked group. The resultant web of contacts and connections as outlined in the previous paragraphs is an important source of potential influence on auditor selection. An auditor selection decision being taken at one company may be being influenced by directors' experiences at other companies (where they will see the work of their own and/or other audit firms; usually the Big 4) and by their other connections with the Big 4.

Those making auditor selection decisions may therefore be comparing what they see with their experience not only in the company concerned but also in the context of the relationships they hold elsewhere. This would suggest that the potential for direct relationship influences.

In addition to their own experiences, the network is also likely to create a number of connections and contacts which are highly likely to promote word of mouth influences (see also Section 2.3.5).

#### **1.4.2. Auditor selection since the demise of Arthur Andersen - infrequent tenders but high switching once instigated**

Against the backdrop of regulatory scrutiny the level of audit tenders each year between the demise of Andersen in 2002 and the issuance of the Corporate Governance Code of September 2012 remained at a relatively low level. According to information provided by one of the Big 4 there were 111 audit

tenders completed by companies which were in the FTSE 350 at the time of the tender, during this approximately ten-year period. Figure 2 below shows the level of tenders each year and the number of companies within this tender population that changed auditors.

This information was compiled from data including that firm's own proposals records and disclosures made in the annual reports of FTSE 350 companies. It is possible that not all tenders have been identified and there may be omissions. This could occur where both disclosures were not made of a tender in the company's annual report and the Big 4 firm had no record. The numbers of these exceptions is considered likely to be small primarily due to the public disclosures that companies are required to make in their annual reports.

Companies' annual reports disclose the name of the company's auditor on the audit opinion contained in the report. Any auditor switches can therefore be easily identified. In addition, even where there has been no change, companies' annual reports also include details of corporate governance and other audit committee activity. It would be highly unlikely for a company to undertake a tender and not explain that they had done so. Such a tender would normally be considered to be part of the corporate governance activity undertaken by the company and overseen by the audit committee and therefore also be disclosed in the annual report.

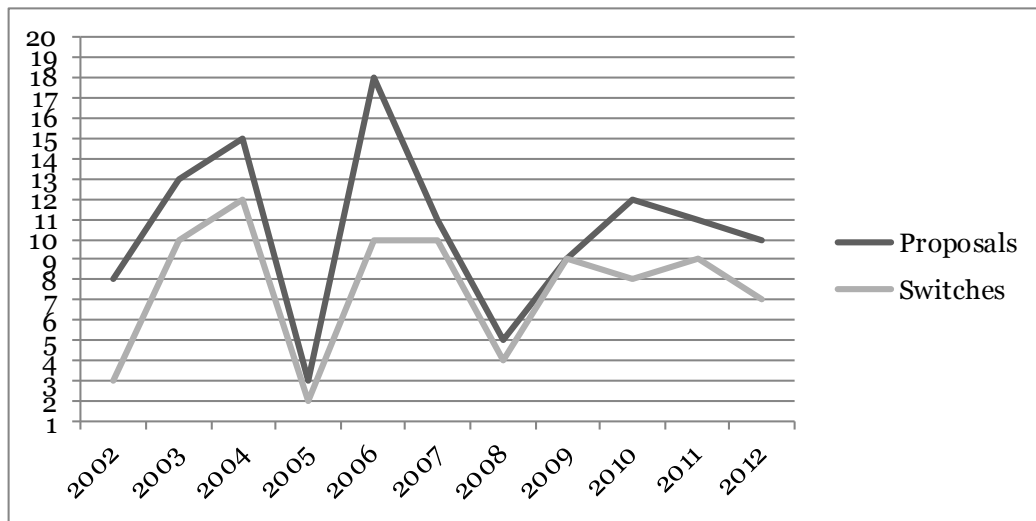


Figure 2: Audit tenders conducted by FTSE 350 companies in the period from the demise of Arthur Andersen in August 2002 to the issue of the UK Corporate Governance Code in September 2012

The statistics suggest that the numbers of tenders as a proportion of the FTSE 350 companies remained low during the period ranging between less than 1% and just over 5% per annum over the period. Put another way, in spite of the auditor appointment being annual, even in the most active year, 95% of companies reappointed their auditor without a tender.

Once a tender was undertaken however the picture changed. The level of switching once a tender had been instigated averaged more than 75% over the ten year period; implying that once a tender was undertaken companies were likely (but not bound) to change. This high level of switching could suggest that tenders may have been being driven by dissatisfaction and/or inherent problems facing incumbent auditors once a tender had been instigated (this is consistent with some previous research which will be returned to Chapter 2, for example Beattie and Fearnley, 1995). In support of the presence of dissatisfaction Oxera (2006) found “Several companies interviewed by Oxera commented that switching may occur (or has occurred) when companies lose

confidence in their auditor, for example because of a fault with the quality of the audit opinion, a breakdown in the working relationship between auditor and management, or an instance of fraud. Dissatisfaction with the current auditor is likely to be one driver of change but there may also be others (for example changes in the company's situation including acquisitions and business expansion). This subject is returned to in Chapter 2 below where the literature concerning auditor switching is explored.

Over the ten-year period, of the 111 completed tenders, 90 audit appointments were lost and only 33 retained. In 12 cases out of the 90 change situations, the new arrangement involved one of the previous auditors, for example, where companies consolidated audit arrangements to one firm from more than one firm.

Table 2 below sets out the number of audit appointments won and lost by firms competing in audit tenders conducted by FTSE 350 companies from August 2002 to September 2012.

The table shows that tenders, consistent with the market positions outlined above, were dominated by the Big 4 firms. Only 8% of companies (See Table 2, first column, 9/111) had an auditor which was not a Big 4 firm before the tender as their sole auditor or as part of a joint audit arrangement. In every case the incumbent non-Big 4 firm lost the appointment following the tender. Where a new auditor was appointed in 96% of cases it was a Big 4 firm.

	Reproposals	Retentions	Losses	New wins	Joint to sole	Net
Deloitte	23	8	15	29	-2	16
Ernst & Young	27	5	22	8	-1	-13
KPMG	25	5	20	18	-3	1
PwC	39	15	24	20	-4	-
Others	9	0	9	3	-2	--4
<b>Firms involved</b>	<b>123</b>	<b>33</b>	<b>90</b>	<b>78</b>	<b>-12</b>	<b>-12</b>
Less: Joint audits	12	0	12	0	12	12
<b>Tenders</b>	<b>111</b>	<b>33</b>	<b>78</b>	<b>78</b>	<b>0</b>	<b>0</b>

Table 2: The outcomes of audit tenders conducted by FTSE 350 companies in the period from the demise of Arthur Andersen in August 2002 to the issue of the UK Corporate Governance Code of September 2012.

Source: Big 4 firm management information

Over the period Deloitte had more wins in total and more new wins than the others; winning more than a third of the appointments where companies changed auditors (29 out of 78 above). KPMG and PwC were broadly neutral whilst Ernst & Young was a net loser. It had the second highest number of losses (including the lowest retention rate of its own clients in re-proposals) and the lowest number of new wins. This may even suggest further concentration within the Big 4 with the smallest firm, Ernst & Young losing ground against the other three in this period. PwC had the highest re-proposal rate in the period although also by the highest re-proposal success rate and the highest number of new wins after Deloitte. KPMG had a similar number of re-proposals as Ernst & Young and a similarly low re-proposal success rate but won substantially more new audits.

Comparing the performance of the Big 4 with the other firms demonstrates the continuing dominance of this group in the FTSE 350 audit market.

There is strong evidence therefore that, although audit tenders in the FTSE 350 during the period of this study were infrequent, they were likely to lead to



an auditor change when they occurred. Because of their dominance, where there was a change, in the majority of cases this resulted in a switch from a Big 4 firm to another Big 4 firm. Furthermore it seems that only Big 4 firms were able to retain audit appointments following proposals. The data therefore support a strong preference for Big 4 firms. This preference for Big 4 firms and auditor switching are returned to in Chapter 2 in the literature review. The statistics above however don't provide insight as to *why* this is the case and in particular how companies might be making a final selection, almost always between the Big 4, further supporting the need for a better understanding of this auditor selection process.

#### **1.4.3. The nature of audit tenders conducted by FTSE 350 companies**

Before concluding on the practical and regulatory influences likely to be influencing auditor selection in the FTSE 350, it is worth considering the nature of the audit tender processes being undertaken. There are two aspects to the process considered here. Firstly the construct of the selection panel where, as will be explored in Section 2.3.5, the behaviour and interaction associated with groups is likely to be relevant to the auditor selection decision. Secondly the structure of the proposal process and the level of interaction that typically takes place. As will also be considered in Chapter 2, the interaction and behavioural influences on decision making are therefore also likely to be pertinent.

In discussing the structure of the selection panel for auditor selection, Oxera (2006) identified four stakeholder influences on the auditor selection

decision; the audit committee, company management (including the company's Finance Director, Chief Executive Officer and/or Chairman), shareholders and external advisers such as lawyers, brokers and investment bankers. According to Oxera (2005) auditor selection decisions were, consistent with regulation (see Section 1.1 above) taken by audit committees but management and especially the Finance Director were also influential. The role of external advisers appeared to exert a preference for a Big 4 auditor, but not between them. When selecting an auditor, those making that decision would be likely to avoid criticism should anything go wrong. The auditor selection decision therefore appears to be one involving a group of people within an organisation and with evidence of influence from outside the organisation. The dynamics of groups and other influences on decision making are returned to in Chapter 2 where relevant literature in this area is explored.

Turning to the process itself; inherently if there are more developed, longer or more intense processes, this is likely to involve more interpersonal interactions during the tender process which in turn may cause behavioural influences to be more pronounced.

According to management information provided by one of the Big 4 firms, audit tenders have typically tended to last for a period of between about a month and, for larger and more complex organisations, several months. During this period a typical process involves meetings between the competing firms and members of management and the audit committee of the companies concerned. These meetings are normally set up to enable audit firms to develop their understanding of the companies involved and to scope their work. In addition to

formal meetings there can also typically be a level of interaction around those meetings including ad hoc meetings, telephone calls and other communications. The process tends to culminate in the submission of a proposal document and normally a presentation to a selection committee.

This information appears to suggest quite a high level of interaction between companies and auditors during proposal processes which would allow behavioural influences to come into play and for decisions to evolve as they progress. NB the Competition Commission Investigation report (2013) referred to above also provides a detailed explanation of the audit tender process and evidence to support a relatively high level of interaction.

The literature concerning the nature of professional services supplier selection processes is considered in Chapter 2 (Section 2.4) along with that which considers behavioural influences on decision making more generally (Section 2.3.3).

### **1.5. Conclusion on the regulatory and practice background**

This section has reviewed the regulatory and practical environment affecting the auditor selection decision. It has identified a number of potential influences on the auditor selection decision:

- The decision takes place in an increasingly regulated environment which can have a high profile, especially when things go wrong. This regulatory environment has been evolving (indeed has continued to evolve and change since the completion of the study – see Chapter 7).

- The market is dominated by the Big 4, who audit almost all of the FTSE 350 and have been selected in almost all of the audit tenders in recent years in this market. This market concentration has created competition authority interest which is continuing. There is evidence of competition in tenders amongst the Big 4 but the data do not explain their relative degrees of success.
- The buying group is led by FTSE 350 company directors who are highly networked implying both past relationship/experiential influences and the likelihood for word of mouth influences.
- Audit tenders have been relatively infrequent but, more often than not, have led to auditor change; perhaps suggesting that whilst strong relationship influences and switching costs may sustain long term relationships generally in this market, prior service dissatisfaction may negate such influences leading up to an audit proposal.
- Audit tenders also appear to be comprehensive processes where behavioural influences are also likely to be present.

Each of these influences is considered further in the literature review that follows.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.0. Introduction

The regulatory and practical backdrop to the auditor selection decision was explored in Chapter 1. This chapter sets out the research context for that decision by reviewing relevant literature.

The approach to the literature review is summarised in Figure 3 and explained in the sections that follow.

An initial review of the literature identified a paucity in relation to auditor selection in the important FTSE 350 market. The approach to the literature review therefore took a broader, exploratory approach.

The review starts by considering traditional supplier selection literature



Figure 3: Summary of the approach taken to the literature review

and then the economic theory on which it has been based. As will be shown, there has been very considerable research concerning the purchase of goods, taking different approaches and including a number of purchasing optimization models based on the principles of rational economics. Such models are commonly based on cost minimisation and on quality and delivery measures. These techniques have become more sophisticated over time. The goods procurement process has also become more complex with closer supply chain relationships with fewer suppliers and strategic partnership approaches being developed.

There is however doubt as to how applicable traditional supplier selection models, focussed on goods purchasing and based on earlier approaches to economic theory, can be in practice. Five areas of challenge to the application of these models are considered in this literature review.

Firstly differences between goods and services have been argued which make it potentially unsafe to apply goods purchasing models to services. Because services differ from goods they cannot, following this argument, be procured in the same way. There are fewer studies of services supplier selection but the extant literature identifies that there are differences in the supplier selection in this sector. The differences between goods and services and services supplier selection are considered in Section 2.3.1.

A second challenge questions whether the traditional normative supplier selection models are applicable at all. It has been argued that it is impossible to optimise value generally and rather that it has to be determined through the

eyes of the buyer and in use. This approach necessitates following collaborative approaches and co-developing service propositions which is inconsistent with normative models. This is considered in Section 2.3.2.

Whilst these first two challenges identified question the applicability of goods based normative models they are not necessarily inconsistent with rational choice theory because the underlying process remains one of rational actors seeking value. The next three challenges however challenge the applicability of economic models generally.

The third challenge comes from behavioural decision theory. This theory argues that in reality decisions are not based on optimality or an objective view of economic rationality, but on human judgements which are neither economically rational nor necessarily consistent. Behavioural decision theory is considered in Section 2.3.3.

A fourth challenge to traditional normative supplier selection models based on rational economic models comes from literature which has identified affective and relationship influences on purchasers. Whilst Section 2.1 will consider the economic benefits of established relationships, other more intangible and not necessarily economically rational influences have also been identified. Affect, trust and loyalty are considered in Section 2.3.4 in this context.

The final challenge considered falls within the area of influences that have been seen to affect decision making in groups, organisations and networks. Traditional models, starting from the position of the rational decision maker

often ignore such influences and their impact on decision making. Such influences have been shown to be often inconsistent with rational economic theory. These influences are therefore considered in Section 2.3.5.

Having explored the general supplier selection phenomenon, this literature review then focusses on professional services supplier selection. A number of specific differences have been identified between professional services and other service purchases. These differences and their impact on supplier selection are then therefore considered in Section 2.4.

Finally, the specific auditor selection literature is considered (Section 2.5) including those factors identified which appear to support the selection of a Big 4 firm over other auditing firms and those which might contribute to understanding selection between Big 4 firms. As noted above there is paucity of literature in this area.

In summary, this chapter identifies a number of themes with apparent applicability to auditor selection but it is surprising that, given the importance of auditor selection discussed in Chapter 1 and with more and more pressure (and more recently compulsion) for FTSE 350 companies to tender their external audits regularly, there is very little relevant academic literature investigating how these important companies select their auditors in competitive proposal processes and what factors are affecting their decisions.

In 1998 Beattie and Fearnley (1998a) explained that, to their knowledge, the audit tender process had not been previously studied and that further



research was warranted (Beattie and Fearnley, 1998a page 96). There has however been little academic research in this area since.

### **2.1. Traditional supplier selection models**

In general, supplier selection literature is very extensive, consistent with the fact that selecting suppliers successfully can be critically important to many organisations. For many, raw materials, purchased parts or outsourced services can be a significant proportion of the total costs of their products (e.g. Ghodsypour and O'Brien, 1998; Van Weele and van der Vossien, 1998) and this proportion has tended to grow as companies have focussed on their core competences after the publication of work by Prahalad and Hamel (1990).

Furthermore suppliers can have an important impact on businesses. This has been seen to include influences on output cost, quality, delivery and service (Amid et al., 2009; Kagnicoglu, 2006) and has wider implications, for example for future revenues through collaborative product development (van Echtelt et al., 2008). And (as expanded on below), as companies have rationalised their supplier bases (Tully, 1995) benefits to business of commitments to fewer suppliers have been identified (Swink and Zsidisin, 2006); further underlying the importance of supplier selection.

### **2.1.1. Supplier selection models – optimising value from transactions**

Much of the traditional supplier selection literature has focussed on optimising a transaction or exchange or a set of transactions or exchanges recognising that the selection decision is likely to be multi-faceted.

In one of the earliest studies, Dickson observed, “From the purchasing literature, it is fairly easy to abstract a list of at least 50 distinct factors (characteristics of vendor performance) that are presented by various authors as being meaningful to consider in a vendor selection decision” (Dickson, 1966, page 5). Dickson’s own research identified and evaluated 23 vendor selection criteria which are set out in Table 3 below.

As the table shows, the factors that Dickson evaluated included a range of criteria which covered elements relating to the goods and their supply (which were most important), attributes of the vendor operation including production facilities and capacity, financial position and management and organisation (which were of considerable importance) and behavioural factors including desire for business and attitude (which were of average importance).

Although Dickson’s study was manufacturing based and an early example of research into supplier selection, the sorts of criteria that were identified (notably quality, delivery and price) as will be returned to below, were also identified by and/or a focus of numerous later studies. A focus on manufacturing in supplier selection continued over a number of years.

Rank	Factor	Mean rating	Evaluation
1	Quality	3.508	Extreme Importance
2	Delivery	3.417	
3	Performance history	2.998	
4	Warranties and claim policies	2.849	
5	Production facilities and capacity	2.775	Considerable Importance
6	Price	2.758	
7	Technical capability	2.545	
8	Financial position	2.514	
9	Procedural compliance	2.488	
10	Communication system	2.426	
11	Reputation and position in industry	2.412	
12	Desire for business	2.256	
13	Management and organization	2.216	
14	Operating controls	2.211	
15	Repair service	2.187	
16	Attitude	2.120	
17	Impression	2.054	Average Importance
18	Packaging ability	2.009	
19	Labor relations record	2.003	
20	Geographical location	1.872	
21	Amount of past business	1.597	
22	Training aids	1.537	
23	Reciprocal arrangements	0.610	

Table 3: Dickson's vendor selection criteria (from Webber, 1991)

In 1991 Webber et al. were able to identify 74 different studies (also restricted to industrial purchasing) relating to supplier selection that had been produced since Dickson's study. They mapped these studies to Dickson's original criteria and considered how they had responded to developments in manufacturing including Just In Time techniques. These studies included conceptual and empirical studies as well as those involving evaluation techniques to analyse different purchase offerings and optimise utility against the business priorities of different organisations (Webber et al., 1991). The most

discussed factors from Dickson's list were net price, delivery, quality and production facilities and capacity. Consistent with the greater demands to meet more stringent delivery schedules associated with Just in Time, Webber found that these purchasing techniques had led to a sustained interest in quality and delivery and also greater interest in geographical location and production facilities and capability as well as net price (Webber et al., 1991).

Over the years considerable focus has been given to developing models which try to introduce greater sophistication into optimizing the supplier selection decision (Huang and Keskar, 2007). Approaches have included models to minimise purchasing costs (Roodhooft and Konings, 1996), total inventory costs (Youssef et al., 1996) and total cost of ownership (Degraeve et al., 2000).

A number of different techniques have been used to identify optimal purchasing outcomes as shown in Table 4 below (see also Ho et al., 2010).

Supplier selection model/approach	Author
Weighted linear models	Lamberson et al. (1976), Timmerman (1986)
Linear programming	Pan (1989), Turner (1988)
Mixed integer programming	Weber and Current (1993)
Grouping methods	Hinkle et al. (1969)
Analytic hierarchy process	Barbarosoglu and Yazgac (1997), Hill and Nydick (1992), Narasimhan (1983)
Matrix method	Gregory (1986)
Multi-objective programming	Weber and Ellram (1993)
Total cost of ownership	Ellram (1995)
Human judgment models	Patton (1996)
Principal component analysis	Petroni and Braglia (2000)
DEA	Narasimhan et al. (2001), Weber and Desai (1996), Weber et al. (1998)
Interpretive structural modelling	Mandal and Deshmukh (1994)
Statistical analysis	Mummalaneni et al. (1996)
Discrete choice analysis experiments	Verma and Pullman (1998)
Neural networks	Siying et al. (1997)

Table 4; Traditional supplier selection models  
(from S. Talluri, R. Narasimhan (2004) page 239)

Ellram (1990) found that studies such as these tended to focus on the ability of a given supplier to meet the immediate need, sometimes considering a number of different scenarios, but with a focus on factors such as price, quality and availability. Their short term orientation tended in turn to a focus on cost.

The supply relationships between organisations have however been evolving and becoming more sophisticated. Purchasing functions have been changing significantly from transaction-orientated order processors to supply managers with an emphasis on adding value and meeting a company's longer term goals (Stanley and Wisner, 2001). Many organisations, as noted above, have reduced their supplier base to facilitate better supplier management (Tully, 1995) and developed cooperative approaches (Mason, 1996). By working with suppliers, more synergistic and longer term benefits have been achieved as illustrated by Table 5.

Benefits of co-operative supply approaches	Author
Building supplier confidence levels and trust	Johnston et al., 2004
Reducing inventory levels	Lee et al., 1997
Minimising transaction costs	Walker and Poppo, 1991
Achieving more cost effective designs and the selection of the best technologies	Monczka et al., 1994
Better use of customer knowledge	Paulin et al., 2000
Operational factors (for example non-retrievable investments, shared technology and relationship influences such as trust and commitment)	Wilson, 1995

Table 5: Benefits of co-operative approaches to supply

The evolution of supply chain management and a resulting focus on longer term and inter-organisational relationships has resulted in organisations managing their supply bases by identifying, selecting and managing suppliers for strategic, long term partnerships as a key ingredient to the success of a

supply chain (Talluri and Narasimhan, 2004). Where such a partnership approach is adopted organisational financial stability, organisational and strategy considerations, technology issues and other organisational aspects also become important (Ellram, 1990). Ultimately, where organisations are working in partnerships and strategic alliances, needs may not simply be dictated by the purchaser but jointly with the vendor (Ellram, 1990). Logically, in a strategic relationship it is not possible to define and predict exactly which products and services may be delivered or developed. These evolve as market conditions; requirements and the nature of the relationship evolve and deepen (Ellram, 1990). And where this degree of cooperation exists, competition can become that of supply chain versus supply chain rather than obtaining at the level of single organisations (Lindgreen, 2009).

Changes in supply chain relationships have therefore added both complexity and additional considerations to supplier selection decision. Whilst it may still be desirable to optimise a set of transactions, much broader considerations are likely to be relevant. As supplier selection decisions have become more complex, it has been suggested that evaluation needs to be undertaken on an inter-organisational rather than on a product basis (Ellram, 1990). Further whilst Ellram considered that existing traditional models could have been used to incorporate more complex managerial or development issues, in practice she found they did not (Ellram, 1990).

The traditional supplier selection literature then includes large number of studies which seek to optimise normative multi-faceted factor models including quality, delivery and cost as well a trend to a greater focus on synergies and

benefits of collaboration through long term partnership approaches between purchasers and suppliers.

## **2.2. Normative economic models of decision making and their limitations**

In seeking to optimise multi-faceted models much of the traditional supplier selection literature has been predicated on an underlying assumption that companies are, or ought to be, aiming to maximise economic utility or minimise economic disutility. This is grounded in rational choice theory (e.g. O'Shaugnessy and O' Shaugnessy, 2005) which suggests that the decision maker ought rationally to choose the option which promises the most valuable expected outcome for them. Whilst the outcome of any one choice can't be guaranteed over a period of choices greater success ought to be achieved by adopting this approach using the laws of probability. Statistical theory has developed to predict the best likely outcome over a series of choices based on probability theory and the binomial distribution. If rational choice theory holds, it follows that: "A simple and comprehensive rule for making decisions is the following: list all feasible courses of action. For each action, enumerate all possible consequences. For each consequence, assess the attractiveness or aversiveness of its occurrence, as well as the probability that it will be incurred should the action be taken. Compute the expected worth of each consequence by multiplying its worth by its probability of occurrence." (Fischhoff et al., 1981, page 391).

Prescriptive models based on rational choice can be attractive because “they reduce the universe of decisions into a common set of primitives options, probabilities and utilities about which one could hope to derive universal truths” (Fishhoff et al., 1981, page 391). It is acknowledged that what constitutes the most valuable outcome (or maximised utility) is likely to be different depending on an individual’s own circumstances and how important the benefits are likely to be to them considering for example their marginal utility (Von Neuman and Morgenstern, 1947). In arriving at the most valuable outcome, some predictions may also have to be made conditional on “guessing” the actions of others (Von Neuman and Morgenstern, 1947) but again based on expected probability.

A number of shortcomings in normative economic models have however been identified. Firstly they are most effective when applied to a number of decisions. There is less likelihood of establishing an effective normality when decisions are one off and different in nature (such as a single company’s auditor selection decision which, as was explained in Chapter 1, is made typically only once in several years). Secondly models based on probability distribution are not good at predicting or explaining highly improbable events (Taleb , 2010). For example if the various financial scandals highlighted in Chapter 1 had been predicted they would not have created such an impact and response. And thirdly, much normative theory does not tend to be a good predictor of decision outcomes given the critical role of judgement. It has been observed that even over a number of instances, decisions don’t tend to follow the pattern predicted



by normative economic models. This aspect is expanded on in Section 2.3.3 which considers behavioural decision theory.

### **2.3. Alternative views – challenges to traditional supplier selection and economic models of decision making**

The previous two sections have considered the traditional supplier selection literature and the normative economic models that have been their foundation. The next five subsections now consider challenges to this literature starting with arguments for differences between services and good and resultant differences for services procurement.

#### **2.3.1. Services differences and services procurement**

##### **Arguments for services differing from goods**

Numerous studies have argued that services are different from goods (see for example Fisk, Brown and Bitner, 1993). Indeed it has been argued that services marketing defined itself by the difference between services and goods (Lovelock and Gummesson, 2004). These differences have commonly been classified under four headings and sometimes referred to as “IHIP”: intangibility, heterogeneity, inseparability and perishability and are explained in the following paragraphs.

Firstly, given the intangible nature of services it is argued services performance cannot easily be seen, felt, tasted, or touched in the same manner as goods (Zeithaml et al., 1985) .

Secondly, services tend to be heterogeneous. The service experience can't therefore be duplicated exactly for each customer (Fitzsimmons et al., 1998; Ziethaml et al., 1985). One of the inherent difficulties associated with services procurement is the high value contribution from people. Because human performance is always unique, irrespective of training and experience, heterogeneity and therefore differences in performance will always be present (Ellram et al., 2004).

Thirdly, whereas the production and consumption of goods can be separated, the production and consumption of a service usually occurs simultaneously and the two are inseparable (Regan, 1963). Customers are often present during at least part of the service production and will interact with employees and other customers (Anhauser, 2011).

Finally, perishability means that services can't be stored (Ziethaml et al., 1985) which means that a service not provided (for example an empty theatre seat or an hour of a employee's time not utilised) represents an opportunity lost (West, 1997).

As a result of these differences, it has been argued that goods and services are evaluated in different ways. Search qualities apply to products which the customer can therefore analyse and evaluate before buying. This may be contrasted to experience qualities, which apply only after purchase during consumption and credence qualities which cannot be easily evaluated by the client, even after consumption, because the client lacks the necessary knowledge or capacity (Darby and Karni, 1973) (the topic of credence qualities and their

impact on supplier selection is returned to in Section 2.4 when professional services are discussed specifically). And as supplies become more intangible, purchasing, it has been argued, becomes even more difficult because quality is less and less easily assessed based on physical outputs and the service decision becomes more complex and difficult because the inputs to the purchaser become vague or ambiguous (Stock and Zinszer, 1987).

Whilst the purchase of highly tangible goods such as simple production components can involve a highly tangible evaluation, this would be impossible for highly intangible services such as consulting (Schonberger, 1978). And although it may be possible to model some repeat standard services such as business travel (see Degraeve et al., 2004) it is likely to be more difficult to assess other services this way.

If goods and services have substantial differences then the application of traditional supplier selection models to their procurement would therefore be unsafe. Literature specific to services supplier selection is considered next.

### **Services supplier selection**

Given the differences between goods and services outlined above, it is perhaps surprising that the mainstream of supplier selection literature remained grounded on goods based supply relationships until relatively recently.

Since 1991 there have been numerous other studies which focus on supplier selection involving the procurement of goods. In comparison the study

of services procurement has developed much more recently. Compared to goods, academic knowledge about services has been more limited. For example in 2003, an analysis of the articles in the *Journal of Supply Chain Management* in the 35 years since its inception showed that of the 774 articles that had been published, less than 10 related to services purchasing (Carter and Ellram, 2003). And even by 2007, Ellram et al. considered that business to business services purchasing had continued to be given relatively little focus (Ellram et al., 2007). Selviaridis and Spring (2010) commented; “Little is known, however, about how complex services actually develop and evolve throughout the purchasing process, from setting the initial requirements to adapting the offering after contract award” (Selviaridis and Spring, 2010, page 171). There was also little research into the differences between purchasing materials and services (Smeltzer and Ogden, 2002).

The historic focus on goods as compared to services in supplier selection is further surprising given the significant and growing contribution of services in major economies; indeed services have been recorded as accounting for approximately two-thirds of GDP in advanced economies (Sako, 2006).

Furthermore the services supplier selection literature has identified a number of differences from goods purchases.

Many of the studies of goods purchases were about how companies ought to construct a list of requirements, weight them and seek to maximise expected utility (or minimise cost) across those requirements. However the business services literature in particular has also highlighted that because of the

intangibility and related uncertainty associated with services, many of these requirements are defined during the sourcing process. Indeed interaction and refinement of service definition is likely to occur both before and after signing the contract with continuous refinement of resource allocation (see for example van der Valk and Wynstra, 2014).

During the services procurement process the precise up-front definitions developed could still be critical to facilitate performance evaluation and minimise supplier opportunism risk (Ellram et al., 2007), but buying firms may be unable to set out detailed specifications from the outset (Ellram et al., 2008) and whilst manufactured goods could be precisely specified and quality measured, services could be subject to changing scope and the assessment of quality could be subjective and user dependent (Ellram et al., 2004). Services therefore can pose challenges for buyers in specifying the service, defining the specific content of any service level agreement and evaluating performance.

Reflecting the dynamic nature of services, requirements may also be defined in different ways and therefore supplier selection based on assessing different things. For example specifications may be based on inputs (focusing on the supplier's resource/capability base), processes (emphasising how the service is produced), function-oriented definitions stressing service functionality and output and outcome-oriented approaches focusing on the service's economic value (with detailed specifications being drawn interactively or left to suppliers) (Axelsson and Wynstra, 2002). These different definitions can have implications for the relationship between the buyer and the seller in business services sourcing (see Selviaridis and Spring, 2010). For example,

where a functional definition is applied there may be substantial scope for the supplier to define the processes and resources used to meet those functional demands (van Weele, 2005) and where supplier and buyer are working together to agree specifications there is a need to carefully manage boundary discussions and higher transaction costs may arise as a result of those discussions (Araujo et al., 1999).

Because of the perception that many services are more difficult to manage, it has also been felt that services procurements are best managed by the user with less or little involvement of supply management or procurement departments who would typically be responsible for or influential in supplier selection. Furthermore where services are regarded as important and strategic they are also most often bought by non-purchasing specialists (Ellram, 2007). In addition it has been argued that there exist strong relationships between non-purchasing specialists and their suppliers which they do not want purchasing specialists to interfere with (Van Weele, 2005). The composition of the audit buying unit is set out in Section 1.4.3. It has been a feature of audit services and, (as will be returned to in Section 2.4), professional services that those responsible for supplier selection have tended to be the users of the service.

So there is literature which asserts the differences between goods and services selection and which highlights particular challenges related to services procurement. But services cover a very wide range of activity and there are many differences in the characteristics of activities within services. A number of different ways of classifying different services have been identified (for a comprehensive explanation of service typologies see Cook, 1999).

One way of looking at this is to consider services as a purchasing continuum according to the degree of tangibility of the good or service being purchased (Schonberger, 1978). However there is a challenge whether restricting such a continuum to services is really meaningful. For example, as supply relationships have evolved, any boundary between goods and services has been blurred. Suppliers of goods have been adding “bundles” of services such as support, self-service and knowledge to support core product offerings; through servitization (Vandermerwe and Rada, 1988). So whereas the historical focus may have sometimes been on product selling with certain services as add on to products, servitization involves the provision of services as a main differentiator as part of an integrated product and services offering (Lightfoot et al., 2013).

The services supplier selection literature therefore argues for differences in the procurement process as compared to goods, dealing with intangibility and greater buyer seller interaction through the procurement process. Cost, quality and delivery requirements may be assessed in different ways and in a more interactive way before, during and after contract signature than envisaged in traditional supplier selection models.

As identified in Chapter 1, the core audit service is defined by law and regulation although Oxera (2006) also argued for insurance and value attributes being sought by audit buyers. The dynamics of service definition for a highly regulated, high profile purchase provide an important area of interest for this study.

### **2.3.2. Value in use and Service Dominant Logic**

A second challenge to the applicability of traditional supplier selection models is posed by those who argue for a different value construct. For those supporting value in use, it is not the fact that goods and different from services that is of primary importance. Rather they argue value is derived in the buyers' terms and cannot be arrived at in a standard way, making unconditional optimisation impossible. This is now considered further.

In 2004, Vargo and Lusch challenged the historically dominant logic (focussed on tangible resources, embedded value and transactions) underpinning the traditional supplier selection literature arguing that it may no longer be sufficient and ought to be superseded by a new Service Dominant Logic (Vargo and Lusch, 2004).

Service Dominant Logic argues that instead of taking a goods centred approach, where the purpose of economic activity is to make and distribute things that can be sold because they are embedded with utility with the aim of maximising profit from the sale of output, an alternative service centred view should be taken. Adopting this service centred logic, organisations ought not to focus on value creation through the production and exchange of goods (or "operand resources" (Vargo and Lusch, 2004), but rather should identify their core competences, identify other entities (potential customers) that could benefit from these competences, cultivate relationships that involve the customers in developing customized value propositions and use analysis of financial performance to learn how to improve firm performance (Vargo and



Lusch, 2004). Following this logic, operant resources which are often invisible and intangible are primary because they produce effects and enable humans to multiply the value of natural resources and create additional operant resources (Vargo and Lusch, 2004). It then follows that services are not different from goods but rather the undeniable core of every marketing interaction (Ballantyne and Varey, 2006). No matter whether good or service, each purchase is driven by a desire to achieve value for the customer with their unique circumstances.

Vargo and Lusch were not the first to question the common differentiation between goods and services. Gummerson (1995) had argued that “Customers ...buy offerings which render services which create value... the traditional division between goods and services is long outdated” (pages 250-251). The concept of a relationship perspective, where value is created partly in interactions between the customer and the supplier or service provider as compared to a traditional value in exchange perspective, had also been introduced by Sheth and Parvatiyar (1995) and is at the heart of relationship marketing (see for example Berry, 1983). Similarly Normann and Ramirez (1993) had argued that with global competition, changing markets and new technologies, the whole value creating systems ought to be considered. They argued for the importance of co-producing value “the goal is not to create value for customers but to mobilize customers to create their own value from the company’s various offerings” (page 69).

Although not the first to introduce these ideas, Service Dominant Logic has created wide academic interest (Vargo and Lusch, 2006; Brown and Patterson, 2009), both from those who support it (for example Rust (2004) and Hunt

(2004)) and from those who challenge it (for example Schembri (2006) and Achrol and Kotler (2006)). Lindberg and Nordin (2008) have argued that as well as Service Dominant Logic suggesting that the emphasis of theory and practice should be moved to the exchange of intangible resources (Vargo and Lusch, 2004), there has also been a move in the opposite direction. Previously identified concepts such as mass customisation (Davis, 1987; Duray et al., 2000) and lean services (Bowen and Yougdaahl, 1998; Levitt, 1972, 1976), supported an approach of standardising and objectifying services. Others have recognised the dilemma faced between customisation and standardisation of services and the compromise offered, for example by what Sundbo (2002) termed “modulisation” . In addition to adding services to goods to create an intangible experience, it has therefore argued that companies are also seeking to standardise services in a “Goods Dominant Logic” . It has been argued that both Goods Dominant Logic and Service Dominant Logic may be operating contemporaneously for services (Linberg and Nordin, 2008).

If services dominant logic is applicable to auditor selection it would be expected that rather than creating lists of requirements for potential auditors and then assessing responses, companies would be looking for auditors to co-develop value propositions with them. In Chapter 1 audit tender processes were discussed and in particular their typically comprehensive nature and level of interaction between companies and their perspective auditors. Such a process is consistent with value proposition development during (and conceivably before) a tender process.

As noted above in Section 1.2.2, the core audit service is defined by law and regulation so there are limits as to the level of co-development and customisation that can take place (and indeed opportunities for standardisation). These limits however do not extend to how the service is designed to be delivered or additional value that might be achieved as part of the augmented audit service (Gronroos, 2007, pages 187-191). Again, as noted above, collaboration and co-creation of value in a highly regulated and high profile environment is likely to be a highly pertinent part of the study.

### **2.3.3. Behavioural decision theory**

The previous two sections have set out two challenges to the application of traditional supplier selection models. The first of these arising from identified differences between goods and services and the second in relation to an alternative view of how value is derived. As previously noted, neither of these is necessarily inconsistent with rational choice theory because underlying both is a desire to optimise utility.

Behavioural decision theory however provides a third and more fundamental challenge because, as previously noted, it argues that decisions are taken in reality not based on optimality or an objective view of economic rationality, but on human judgements..

Normative economic theories tend to assume that probabilities used in calculating expected utility are objective; they exist in nature. As early as 1926 Ramsey offered an alternative; that probabilities were driven by the actors' beliefs concerning likely outcomes and this involved judgement (Ramsey, 1926).

This could be deduced from their behaviour i.e. if an actor bet on a horse that was evidence that he believed it would win. Subjectivity could extend both to the decision maker's valuation of the consequences based on his utility and the probability measure of the outcome based on his beliefs (Savage, 1954). Whilst it may be possible that decisions involved high degrees of objectivity and predictability, this would depend on the nature of both the utility and probability models applying (Edwards, 1955) (NB one challenge levelled at some of the supplier selection models and set out in Section 2.1 is about how decision weightings are identified and how realistic and reliable forecasts are).

Optimality itself is also likely to be conditional both in terms of situation and time. What is apparently optimal in one situation may not be in another (Einhorn and Hogarth, 1981). Also since people learn, it may be difficult to know which was right when optimality as expected appeared to conflict with human judgement. Was human judgement more accurate or an error? (Einhorn and Hogarth, 1981).

Another assumption underlying traditional economic models is perfect information. In reality this is highly unlikely to hold in anything other than the simplest decision. Individual decision making, it has been posited, instead operates within bounds (Simon, 1997). This "bounded rationality" occurs for at least three different reasons:

1. Rationality requires a complete knowledge and anticipation of the consequences that will follow each choice – in practice this is not available,

2. Since consequences lie in the future, imagination has to be applied in attaching value to them, and
3. Rationality requires choice among all possible alternatives when in fact only a very few ever come to mind (Simon, 1997).

“It is impossible for the behaviour of a single isolated individual to reach any high degree of rationality. The number of alternatives he must explore is so great, the information he would need to evaluate them so vast, that even an approximation to objective rationality is hard to conceive” (Simon 1997, page 93).

Faced with so many options and possibilities rather than optimise, a typical decision maker (“Administrative Man”) is likely to “satisfice”; looking for a course of action which is “good enough” (Simon, 1997). Rather than dealing with the real world, the administrator deals with a perceived world of bounded rationality which is drastically simplified; a world it is argued of trial and error and habit; building on what has worked before rather than fully evaluating every possible alternative (Simon, 1997).

Rather than following normative economic theory, it has further been argued that an individual’s behavioural intentions are immediate antecedents to behaviour and are a function of salient information and beliefs about the likelihood of performing a particular behaviour will lead to a specific outcome (Fishbein and Ajzen, 1975). It follows from these studies that understanding behaviour is not about rational economic models, but more about understanding individuals’ attitudes towards performing a specific behaviour

and their subjective norms. Information or salient beliefs affect intentions either through their influence on attitudes or individual subjective norms (Fishbein and Ajzen, 1975). The theory of reasoned action (Ajzen and Fishbein, 1980; Fishbein and Ajzen, 1975) identified three boundary conditions:

1. The degree to which the measure of intentions and behavioural criterion correspond with respect to their specificity;
2. The stability of intentions between the time of measurement and performance of behaviour; and
3. The degree to which the intention is under the control of the individual (Fishbein and Ajzen, 1975).

Subsequently the theory of planned behaviour (Ajzen, 1985) built on the earlier theory by extending the boundary condition in relation to an individual's volitional control. This latter theory included the influence of beliefs regarding the possession of requisite resources and opportunities. Hence an individual's motivation for performing a behaviour is also influenced by their beliefs concerning whether it can be achieved (Ajzen, 1985).

There is therefore substantial evidence that human decision making does not follow that predicted by normative economic theory, even over a series of observations. Indeed conversely there is considerable evidence of the application of a number of heuristics which introduce apparent systemic irrationality into decision making (Kahneman and Tversky, 1979; Kahneman et al., 2007; Kahneman, 2011). These include, for example, irrational judgements about an observation's representativeness of a population (for example

overstating preconceived stereo types) and the accessibility of information (overstating the importance of observations most easily brought to mind). Assessments have also been observed to be impacted by insufficient adjustment from where they start or “anchoring” (Kahneman et al., 2007; Kahneman, 2011). There is also a tendency according to Prospect Theory (Kahneman and Tversky, 1979) for decision makers, as compared to what might be predicted under expected utility theory, to exhibit risk averse behaviour in relation to gains (respondents tended to choose smaller certain gains over larger probable gains) and risk seeking in relation to losses (respondents tended to choose larger probable losses over smaller certain losses), (Kahneman and Tversky, 1979).

Where decisions are complex, people appear not to be able cope with all the influences on the decision and therefore it has been argued they fall back on what the situation feels like using what has been called “System 1” (Kahneman, 2011) which processes more routine or familiar decisions intuitively rather than System 2, their significantly more limited capacity for consciously thinking and processing decisions (Kahneman, 2011; see also similarly Thaler and Sunstein, 2008).

It has been elsewhere argued that people store experiences and emotions, of good and bad situations which generate feelings about and expectations of situations being faced; using both rational thought and subconscious emotion developed from past experience to make decisions in complex situations (Lehrer, 2009). Following this argument where decisions are complex, the rational brain can’t cope with all the influences on the decision and therefore the decision rests on what the situation feels like (Lehrer, 2009). Attitudes and

behaviour may also be impacted by decision makers' *general* experience which will have created tastes, preferences and identity (Aspara et al., 2008).

In dealing with complexity and ambiguity, it has also been argued that individuals have to fall back on what has gone before; trying to match the decision with a similar situation in the past. Recognition Primed Decision Theory (Klein, 1993) suggests that the first step in decision making is to assess whether the situation currently faced is familiar (the same or similar to one that has been met in the past). If familiar, attention turns to what to do and the decision maker runs a mental simulation of a potential course of action; considering what happened last time the situation was faced. This may identify an acceptable solution. If not, the decision maker will try mental modifications then run the simulation again and again until a solution is identified.

A variation on this approach is offered by Image Theory (Beach, 1990; Beach and Connolly, 2005). This theory suggests a decision process consisting of assessing options against previously developed personal standards. Individuals it has been argued use their store of knowledge (images) to set standards, driving goals about what to do and plans as to how to do it. Options that don't meet these standards are filtered out and the best remaining option chosen (Beach, 1990; Beach and Connolly, 2005).

Based on the preceding paragraphs those arriving at a decision in uncertain and intangible circumstances, such as that of auditor selection, are likely to be influenced both by natural bias and their past experience. For institutions past experience may even be codified and translated into standard



operating procedures (Simon, 1979) or less precisely set out in policy (although as will be discussed in Section 2.4) professional services have been amongst the least formalised areas of purchasing). Where standard operating procedures and policy has been developed the decision is less about which gamble gives the best return; more about how well decision compares with those standard operating procedures and/or policies (Simon, 1979).

Behavioural influences on decision making have also been supported in other contexts, for example in relation to voting behaviour. In addition to rational choice, (which, they argued, itself may be adapted or constrained to the extent that decision makers would only collect information up to the point where the benefits of collecting further information ceased to outweigh the costs of collecting that information) Lau and Redlawsk (2006) identified three other models of decision making all involving behavioural influences as set out in Table 6.

<b>Models of individual decision making in voting situations</b>	<b>Salient features</b>
Early Socialization and Cognitive Consistency	Where decision makers are less personally concerned, they tend to fall back on past experience and or affiliations, seeking to align what they see and hear in the selection process with their own beliefs, seeking to avoid cognitive dissonance (Festinger, 1957), in other words something which makes them feel uncomfortable
Fast and Frugal	Decision makers only focussing on the very few attributes of judgement that they really care about
Bounded Rationality” (Simon, 1997) and intuitive decision making	Decision makers consider information only up to the point where a satisfactory result is identified. This has also been referred to as “low information rationality” (Popkin, 1991).

Table 6: Models of voting behaviour (from Lau and Redlawsk (2006))

The implications for Lau and Redlawsk's models to auditor selection are that conceivably, rather than behaving economically rationally, buyers may seek to identify facts to support their pre-existing preferences as to which audit firm to appoint or focus on a particular problem to be solved without looking across a broader set of criteria, or satisfice (as defined by Simon, 1979 and discussed previously).

The importance of behaviour in the selling process is of course also well documented in the sales literature with a number of studies considering its impact from a number of perspectives. These have included for example in evaluating salesman performance, (see for example Pasold, 1975), in assessing the impact of adapting in sales generally (Predmore and Bonnice, 1994) and specifically the relationship of adapting behaviour to sales success (Marks et al., 1996). Holbrook and Hirschman (1982) conclude that while much buyer behaviour can be explained by the information processing approach, supplementing it with an experiential perspective can be greatly enriching.

Payne et al. (2008) have also considered the role of interaction or "encounters". They identified different types of encounter (emotionsupporting, cognitionsupporting, valueexplaining and behaviour and action supporting encounters) which would impact customers in different ways; customer decision making being affected not only by their objectives but by their experiences.

The application of behavioural decision theory to auditor selection has important potential implications. It is likely, given the importance and profile of the decision and the seniority of those involved that individuals will at least

strive and/or be seen to strive to make a decision in the interests of shareholders and this might drive them to seek an economically rational decision. In reality because of the extent of the information which may be relevant to the decision (much of it unknown) and the apparent inherent distortions in individual decision making, an objective rational choice is likely to be impossible and decisions are likely to be highly subjective. The challenge to discovering the factors affecting the auditor selection decision is therefore to see it through the lens of the decision makers. It is their interpretation and beliefs about the decision which is likely to explain outcomes rather than economic rationality and this has been reflected in the research approach as will be explained in Chapter 3.

This section has considered a number of factors which have been observed to distort decision making from that which might be expected following a normative economic model. It suggests that in a complicated auditor selection decision, normative predictive models are unlikely to be very reliable. It has also identified subconscious influences on decision making.

#### **2.3.4. Relationship influences on decision making -**

##### **Affect, trust and loyalty**

The fourth challenge to the application of traditional supplier selection models to professional services, and as a subset, auditor selection comes from the influence of relationships.

Many studies have stressed the importance of long-lasting relationships between companies and their customers (for example Sheth and Parvitiyar,

1995 as referred to in Section 2.1.2). The important role of relationships in value creation was discussed in Section 2.3.2. The different nature of exchange in the context of an ongoing relationship has also been argued (see for example MacNeil 1978; 1980), along with the positive impact of relationship marketing on sales, market share and profit (Crosby et al. 1990; Morgan and Hunt, 1994) and the link between relationship quality and purchase intention (Rajaobelina and Bergeron, 2009; Wong et al., 2007).

The studies so far considered have had a focus on value, the economic benefits of relationships. Other, more intangible influences on decision making have however also been identified. Within this literature considerations of affect, trust and loyalty have been especially prominent. This section therefore now considers literature in relation to each of these topics in turn.

### **Affect**

The role of affect as an area of focus has been driven by recognition that the study of traditional cognitive processes has been inadequate to understanding a number of aspects of purchasing and sales situations (Erevelles and Fukawa, 2013).

Affect has been used to describe “an internal feeling state” (Cohen and Areni, 1991). Emotion and mood are instances of this where emotion is generally considered to be shorter lasting and higher intensity than mood (Bagozzi et al., 1999) and is generally associated with a particular object whereas mood is generally independent of any object (Clore et al., 2001). The

importance of emotion has been identified, both its influence on relationships and behaviour.

In connection with relationships, emotion has been seen to play a critical role in their development from initiation, through development and then to sustenance (Andersen and Kumar, 2006; Witkowski and Thibideau, 1999). Emotion has also been observed creating a positive relationship atmosphere (Hallen and Sandstrom, 1991; Sandstrom, 1992).

The importance of affect in the context of decision making is that emotions have been argued as having an immediate and direct impact on an actor's behaviours (Andersen and Kumar, 2006). Empirically evidence exists that positive affect enhances people's willingness to initiate conversations (Batson et al., 1979), to take moderate risks (Isen and Patrick, 1983) and to prefer collaboration over avoidance as a means of resolving conflict (Baron, 1984).

Positive affect has also been identified as increasing the likelihood of actors to find ways in which the interests of the individuals involved in interaction are satisfied in a creative way (Walton and McKersie, 1965). Similarly where negotiators like each other they are more likely to come up with flexible solutions (Walton and McKersie, 1965).

Strong positive emotions have been seen to enforce over-ruling analytical heuristics and jumping to conclusions thereby impeding rational decision making (Gallois, 1994).

Conversely it has been suggested that agitation related emotions such as tension, anxiety and fear, lead people to withdraw from interaction whilst dejection related emotions lead actors to be more aggressive in their behaviour (Higgins, 1987).

It is not generally agreed whether emotions drive behaviour directly or indirectly by stimulating cognitive processes which then drive behaviour (Baumeister et al., 2007), however whether directly or indirectly, emotions in interaction can be seen to exert a number of influences over the way that decisions are framed, the processes and behaviour undertaken to take decisions and resolve conflicts and ultimately in the outcome of decisions through affecting the actors attitude towards potential outcomes.

The affective influence on decision making is also unlikely to relate solely to relationship experience with particular suppliers. The buyers' attitudes and behaviour may also be impacted by their *general* experience which will have created tastes, preferences and identity. Aspara et al. (2008), for example, described "Affective Self Affinity" (page 2) which is "the extent to which an individual perceives a positively affective congruence between the thing and his/her identity". The definition presupposes that individuals have a sense of self and are self-aware so can assess themselves or their identities in relation or in contrast to surrounding objects (Rosenberg, 1979). Also, if an individual has a positive affective self-affinity with one "object", he or she is likely to have positive affinity with others connected with it (Aspara et al., 2008). Sirgy (1982) further suggested that congruency assessments extend to intangibles such as services, people and ideas.

The implications of this work are that if a key buyer has a positive affective self-affinity with a seller and/or attributes of that seller, they are more likely to purchase goods and services from that company. The theory shares some commonality with identification and social interaction theories which argue for an attraction to people or objects that one can identify with (although identification in this context is usually seen as following a cognitive assessment (Bhattacharya and Sen, 2003)).

Within psychology it has been widely explored that attachment can develop to people (Bowlby 1979; Thompson et al., 2005) or to objects or brands (Kleine and Baker, 2004). Attachments can be formed in personal development or even in biology and/or due to the mental nature of people. Attachments can also sometimes be very strong, even passionate (Kleine and Baker, 2004) such that their influence on any decision or selection process would be potentially both strong and difficult to change.

As will be discussed further in Section 2.4 studies of professional services selection (for example Sands and McPhail, 2003) have not explicitly explored the influence of emotion in interactions although they have often inferred them in other criteria for example “client orientation” and “reliability and courteous accessibility”. Similarly, as will again be returned to in Section 2.5, studies have also identified an important influence of personal chemistry in auditor selection and acknowledged the need for further research in this area (Beattie and Fearnley, 1995).

So affect and specifically emotion has been widely researched as an influence on behaviour and relationships. Within business relationships two critical affective influences which have also been widely discussed within a buyer-seller context are trust and loyalty. These are discussed next, starting with trust.

### **Trust**

Trust, it has been argued can be important to a supplier selection decision because a buyer will seek a supplier who “is able to perform effectively and reliably (credible) and is interested in the customer’s best interests (benevolent)” (Doney and Cannon, 1997, page 36).

Trust has been considered in general terms but “blanket trust” is not often applied (one might trust someone to do one thing but not another; either because of good experience in one area but not another or perhaps no experience of another (Blois, 1999)). Baier (1986) stresses that “there needs to be an answer not just to the question: “Whom do you trust? But to the question: “What do you trust to them?” (page 236).

A wide variety of definitions of trust has been developed and as Blois states (1999, page 197): “a great diversity of views exists as to what trust is”. Table 7 is taken from his summary.



Definition	Author
“an attitude displayed in situations where.. a person is relying on another person, a person is risking something of value and/or a person is attempting to achieve a desired goal”	Bialaszewski and Giallourakis, (1985, page 207)
“the degree to which the channel member perceives that its relationship with the supplier is based upon mutual trust and thus is willing to accept short term dislocation because it is confident that such dislocation will balance out in the long run”	Anderson et al. (1987, page 87)
“one party’s belief that its needs will be fulfilled in the future by actions undertaken by the other party”	Anderson and Weitz (1989, page 312)
“one party’s belief that another company will perform actions that will result in positive outcomes for the firm, as well as not take unexpected actions that would result in negative outcomes for the firm”	Anderson and Narus (1990, page 45)
“a willingness to rely on an exchange partner in whom one has confidence”	Moorman et al. (1992, page 315); Schurr and Ozanne, (1985, page 940); also Ganesan (1994)
“existing when one party has confidence in an exchange partner’s reliability and integrity”	Morgan and Hunt, (1994a, page 23)
“perceived credibility and the benevolence of a target of trust”	Doney and Cannon (1997, page 36)

Table 7: Definitions of trust (adapted from Blois (1999), pages 197 to 198)

The table highlights a number of themes surrounding trust including the attitude of those placing trust to those trusted, their willingness to rely on them and a preparedness to accept short term dis-benefit in the belief and confidence that there will be positive benefits in the future

It has been argued that trust may occur not only among individuals but also among organisations as similar sentiments can occur between collective entities. Inter-organisational trust has therefore been distinguished from interpersonal trust. Furthermore organisational joint history serves to create confidence and the creation of effective sanctions and rewards which sustain and enhance the development of trust between organisations (Gulati et al., 2008).

It has been suggested that trust can be further divided to include salesperson trust, product trust and company trust, in each case representing a

belief that the person, product or organisation will fulfil all its obligations as understood by the buyer (Plank et al., 1999).

The deemed importance of trust is perhaps demonstrated by the spread of research concerning its development and antecedents examples of which are set out in Table 8.

Antecedents of trust	Author
Formal and informal sharing of information	Anderson and Narus, 1990
Shared values	Morgan and Hunt, 1994
Disclosing, signalling and initiating behaviours	Leuthesser and Kohli, 1995
Calculation of mutual benefit, reliable mutual prediction, proven capability and demonstrated intentionality	Doney and Cannon, 1997
Societal or cultural norms	Sako, 1994; Vaux Halliday, 2004
Personal characteristics	Wood, 2008
Non -verbal cues, social cues and shared group membership	Huang et al., 2008

Table 8: The antecedents of trust

The positive role of trust in relationships has also been widely documented as shown in Table 9.

Benefits identified	Author(s)
Increased commitment	Geyskens et al., (1999)
Long term orientation	Ganesan (1994)
Increasing cooperation, reducing uncertainty and promoting what they called “functional conflict” (the positive friction that sustains and helps develop relationships through shared differences and problems over time).	Morgan and Hunt (1994, page 22)
Significant impact of trust on intention of future enhancement in a relationship.	Selnes (1998)
Positive influence on current purchase intentions and in reducing uncertainty for consumers; trust operating as an information surrogate in circumstances of information shortage about the quality of a product or service	Sichtmann (2007)
important role in influencing a customer to maintain and build a relationship	Liang and Wang (2006); Shekhar and Gupta (2008)
A key determinant of relationship quality	Swan et al., (1999); Ganesan, (1994)

Table 9: The positive role of trust in relationships

As the table illustrates, a number of benefits of trust have been identified. It is however not clear if suppliers are selected because they are, comparatively, most trusted. Although their study was undertaken in the industrial manufacturing industry (where there is likely to be less uncertainty than in professional services and potentially therefore less reliance on trust) Doney and Cannon (1997) found that trust was important as a short listing factor but neither trust in an organisation nor in a salesperson influenced purchase choice and that factors such as price and reliable delivery were found to be more important.

In the specific auditor appointment situation with high levels of intangibility and the auditor's substantial responsibilities and autonomy (as discussed in Chapter 1), it would seem likely that establishing trust is likely to be an important influence.

### **Loyalty**

Given the long period of tenure of auditors one might also expect high degrees of loyalty in relation to auditor appointment however the high switching rates would perhaps suggest that there are low levels of loyalty in the specific situation of the audit proposal.

Although the direct link from satisfaction to purchase behaviour has been questioned (Hepworth and Mateus, 1994), there is significant evidence of a positive impact of satisfaction as an antecedent to loyalty through repurchase behaviour (Sambandam and Lord, 1995) and repurchase intent (Andersen and Sullivan 1993; Cronin et al. 2000).

Loyalty however has not necessarily been found to guarantee or dictate a purchase decision. Oliver (1999) identified four consecutive phases of loyalty. Firstly, cognitive loyalty which results from an assessment of available information resulting in a conclusion that one offer or brand is better than another. Secondly, affective loyalty which results from a liking or attitude toward the brand based on several satisfying experiences. Thirdly, conative loyalty, which implies a commitment and therefore ties the customer more tightly to the supplier. However in order for a purchase decision to be implemented a fourth phase, active loyalty has to be achieved. Under this last phase the positive motivation to purchase overcomes any obstacles that might prevent the act.

Kuenzel and Krolikowska (2008) have extended the exploration of the impact of loyalty and commitment by looking at bonds in professional services and in particular audit relationships. The existence of relationship bonds (as defined in the social psychology literature) could act as a strong incentive to choose to work with existing, known people and organisations as opposed to others. Two types of bonds have been identified; the social bond (Seabright et al., 1992) and the knowledge bond (Halinen, 1997). Kuenzel and Krolikowska (2008) found that social bonds as well as knowledge bonds were important to commitment.

The long periods of appointment associated with audit appointments as set out in Chapter 1 may suggest evidence of loyalty although other factors such as switching costs are also likely to be important. Also, as noted in Chapter 1 and

will be returned to in Section 2.6, audit tenders have often been associated with problems with the incumbent auditor.

Loyalties may however exist outside of the relationship of a company with its auditor and these are considered later in section 2.3.5.

### **2.3.5. Groups, organisations, networks and word of mouth**

As set out in Chapter 1, the auditor selection decision by FTSE 350 companies is made by a selection group typically involving non executives and management. This group is operating within a corporate organisational context and in a highly networked environment with other and with resultant likelihood of word of mouth influences. The influence of groups, networks and word of mouth is therefore considered next.

#### **Group behaviour**

A number of factors in and around a group have been seen to affect decision making. For example the overall objectives set for the group are likely to steer thinking (e.g. many decisions are driven by a desire to achieve quality but other factors such as the acceptance of the decision by others or the need for originality can be more important (Stumpf et al., 1979)). There may also be established group rules and protocols. A group cognitive style may develop dependent on the styles and social interactions of those involved (Leonard et al., 2005); Under certain conditions groups can make poor decisions through a lack of application of individual judgement and challenge (Janis, 1983; Neck and

Moorhead, 1995) given that individuals in groups are likely to be influenced by the majority view (Asch, 1951).

Individuals who favour a particular outcome or selection may also act as an advocate for it (Krapfel, 1985), or speak louder or more often and through that behaviour change the decision (Hunsekar, 1983). The power of individuals in the group may come from a number of sources including their expertise, authority and the respect that they have within the group (French and Raven, 1959, Thomas, 1984), or their tactics, such as recommendations, threats and promises (Frazier and Summers, 1984).

A buyer's decision may also be influenced by the role they are assigned or adopt within a group (Carlson et al., 2000). The buyer could be representing a constituency of stakeholders, or a position, or an area of expertise. In these cases both the interaction with the group and the buyer's final decision may be different from that expected solely considering their own individual best outcome. A decision could also be influenced by the resources available to the group for example information and the way that it is shared (Larson et al., 2004).

Lastly, a buyer may be influenced by their sense of obligation to the group or broader society. In this regard Etzioni (1988; 1993) argued that there were three sources of influence on the decision maker; utilitarian, social and deontological. Utilitarian corresponding to the individual utility of prescriptive theory, social which comprised the codes in operation in that individual's wider community, and deontological reflecting the moral and ethical considerations

that guide the individual. These latter deontological influences were driven by the individual's own sense of obligation, duty and conscience (Etzioni, 1988; 1993). Social influences came from those around the individual (fear of ostracism if accepted codes of conduct were crossed).

In considering the auditor selection decision these group influences seem to represent other potential influencing factors and yet, as will be considered in Section 2.6, the auditor selection literature has focussed on the individual decision maker. As well as general group influences, those making decisions also do so in the context of their own corporate environment and the networks within which they operate. Before concluding on influences on individual decision makers the next two sections therefore consider these organisational and network influences.

### **Organisational buying behaviour**

The difference between individual and organisational decision making was highlighted many years ago by Webster and Wind (1972) who suggested a general model of organisational decision making. This general model recognised that organisational decision making usually involved many people in the decision making process with complex interactions among those people including who were influenced by both individual and organisational goals (Webster and Wind, 1972).

Webster and Wind further suggested that organisational decision making was influenced by four variables which were individual, social, organisational and environmental. Within each of these variables they recognised rational

economic influences on decision making within a ‘task’ category and other influences such as emotion, personal goals and internal politics which they termed non –task (Webster and Wind,1972). The classifications and examples of variables influencing organisational buying decisions identified by Webster and Wind (1972) are set out in Table 10 below.

	<b>Task</b>	<b>Non task</b>
Individual	Desire to obtain lowest price	Personal values and needs
Social	Meetings to set specifications	Informal off-the job-interactions
Organisational	Policy regarding local supplier preference	Methods of personnel evaluation
Environmental	Anticipated changes in prices	Political climate in an election year

Table 10: Webster and Wind (1972) classification and examples of variables influencing the organisational buying process

Webster and Wind (1972) therefore identified organisational buying behaviour as a complex process involving many people, multiple goals and potentially conflicting decision criteria. In turn these decision criteria would go beyond purely rational economics. Although ultimately decisions were made by individuals who were motivated by a complex combination of personal and organisational objectives, they were constrained by policies and information filtered through the organisation and influenced by others involved in the buying process (Webster and Wind, 1972).

Others have developed similar models (for example: Robinson, Faris and Wind, 1967; Sheth, 1973) which recognise organisational buying behaviour having complex contextual or situational influences (such as environmental , organisational and group), going beyond individual decision making (see also example Johnston and Lewin, 1996)



As will be discussed in Section 2.5, the professional services buying situation within an organisation typically differs from other types of buying within organisations because the buyer is normally the user, with traditionally less or no involvement of professional procurers.

### **Networks and word of mouth**

The previous sections considered some influences likely to affect the decision maker in a decision making group and within an organisation. There are however also likely to be influences outside this unit. Indeed it can be difficult to identify the buying unit when there are other influences inside or outside the organisation which can have a significant impact on an individual buyer and a decision (Silk and Kalwani, 1982).

In reality a transaction is likely to occur in the context of a web of activity some of which is anonymous but much influenced by established interpersonal relationships (Jackson 2006). Network theorists have argued that socially “negotiated” structures exist which keep order and heavily influence the decision making of individuals (see for example Strauss et al., 1963).

The influence of the network may vary depending on the position of the individual relative to others in the network (for example proximity (Rice and Aydin, 1991) but its impact on decision making processes can be significant. It has been argued that informal decision networks both within teams and throughout organisations can systematically bias the way decisions are made (Cross, Thomas and Light, 2009). Allen (1977) for example, found that engineers and scientists looking for information were five times more likely to

turn to friends or colleagues than to electronic and paper based repositories (the age of this study is acknowledged).

Word of mouth has been seen generally to play a significant role in consumer behaviour and sales (Goldenberg et al., 2001). People can be influenced by others even if they have only tenuous or random relationships with them (weak ties) as well as more stable, frequent and intimate relationships from their personal networks (strong ties) (Granovetter, 1973). Although strong ties appear more likely to be influential in consumers' decisions, weak ties appear more likely than strong ties to facilitate word of mouth referrals (Brown and Reingen, 1987).

Within business to business, word of mouth effects have been seen to be strong for example in service promotion (Berry and Parasuramen, 1991) and outweighing the direct influence of advertising and sales promotions (Park et al., 1988). This importance has been connected with both pre and post purchase word of mouth (for example Andrus et al. 1990, Bolting 1989, Richins, 1983).

Positive word of mouth all other things being equal has also been shown to have a major effect on purchase decisions (Arndt 1967; Herr et al., 1991). Others have also shown that negative word of mouth is at least as powerful as positive (Blodgett et al., 1993; Mangold, et al., 1999; Richins, 1983).

Most of the literature on word of mouth has so far concentrated on its overall impact on sales and marketing performance. There is less specific research on the receiver (Sweeney et al., 2007, Bansal and Voyer 2000, Gremler, 1994) and therefore on how word of mouth may be affecting the

decision maker. One exception is Sweeney et al. (2007) who concluded that word of mouth was most likely to be acted on when the receiver needs further information about the product or service, they have limited time for comparison and when they want to reduce the risk of purchase. Corporate buyers have also been observed to solicit positive word of mouth from other customers and weigh that input heavily in their service provider selection (Gould, 1988; Kotler and Bloom, 1984).

Reingen and Kernan (1986) found word of mouth to be critical in a professional services context (although their study was constructed in a business to consumer context). Kotler and Bloom (1984) argue for the need to manage of word of mouth referrals in professional services.

The presence of network influences on auditor appointment was identified by an early Australian study (Davison et al., 1984) which found a connection between audit appointments and cross directorships. Although this study predated the changes in the auditing market explained in Chapter 1 and was in a different geographical context, the potential for network influences seems likely to still persist. The positive influence of alumni relationships which, as noted in Chapter 1, are prevalent in the FTSE 350 provides another example of influences on auditor selection emanating from connections outside the company. Iyer et al (2000) and Lennox and Park (2007) found positive correlations between auditor appointments and other economic benefits to firms where their alumni were present in target companies.

The high intangible or credence properties which make it difficult for a purchaser to evaluate (Parasuraman et al., 1985) provide potential for selectors to seek reassurance from others.

The highly networked nature of the FTSE 350 with cross directorships, alumni relationships (as referred to above) and other networks in the FTSE 350 as explained in Chapter 1 add to the potential for such influences to be high. This influence has however not been a recent focus in the auditor selection literature.

#### **2.4. Professional services procurement**

The previous sections have discussed the traditional supplier selection studies based on normative economic theory and a number of challenges to their application. This section now focusses in on relevant professional services selection literature more specifically before the auditor selection literature is considered in Section 2.5.

##### **The nature of professional services**

Professional services have been classified to include; accounting, auditing and bookkeeping services, advertising agencies, business and management consultancy services, engineering and architectural services and legal services (Stock and Zinzser, 1987).

A number of studies have identified particular attributes of professional services which suggest they differ from many other services. These were summarised by Ojasolo (2007) and are set out in Table 11.

Characteristic of professional service	Author
Provided by qualified persons with a substantial fund of specialist knowledge	Wilson, 1972; Sarkar and Saleh, 1974; Gummerson, 1978; Gardner, 1986; Payne, 1986; Hayward-Farmer, 1988)
Problem solving approach	Wittreich, 1966; Gummerson, 1977; Hill, Garner and Hanna, 1989; Mayere, 1991; Day and Barksdale, 1992
Operation based on assignments	Gummerson, 1978; Gardner, 1986
Code of ethics	Greenwood, 1957; Wilson, 1972; Gummerson, 1981a; Bloom, 1984; Mansen and Stephen, 1984
Societal acceptance	Kleingartner, 1967; Mansen and Stephen, 1984; Swartz and Brown, 1991
Professional association	Wilson, 1972; Bloom, 1984; Mansen and Stephen, 1984
Confidentiality	Gummerson, 1981a; Wheeler, 1987;
Marketing based on understanding customers' fundamental problem, social contacts and referrals important	Wittreich, 1966; Gummerson, 1981a,b,c; Harris, 1981; Wheeler, 1987; Zinser, 1987; Edvardsson, 1988; Hill, Garner and Hanna, 1989; Hill and Neeley, 1989; Hart Shlesinger and Mayer, 1992
High degree of customer uncertainty	Wittreich, 1966; Gummerson, 1978; Bloom, 1984; Wheeler, 1987; Swartz and Brown, 1991; Nooteboom, Zwart and Bijmolt, 1992
Affected by characteristics of information	Cleveland, 1982; Mason, 1992

Table 11: Characteristics of professional services (adapted from Ojasalo, 2007)

As the table shows, professional services are characterised by high degrees of uncertainty for buyers where suppliers have high degrees of expertise and are commonly working on one off project type assignments.

Professional services can also be strategically important to companies as a source of knowledge and to enable innovation (Bessant and Rush, 1995; Muller and Zenker, 2001; Perner et al., 2014). This might be compared for example with simple, lower paid manual work which is less expensive and less risky to purchase (West, 1997).

If a service involves a large amount of expertise, is seen to be of critical importance, is recommended to others, involves quality criteria which are difficult to evaluate and where the nature of the service to be provided is

unclear, it is likely to be considered to be a professional service (Thakor and Kumar, 2000).

Furthermore, the application of knowledge and expertise has been considered critical in professional services and the ability of professional service firms to attract, mobilize, develop and transform the highly educated employees they need to create value for their clients (Lowendahl et al., 2001; Sonmez and Moorehouse, 2010). The high level of professionals possessing expertise gained through formal higher education and the exercise of judgement in delivering the service have also been seen as an important feature of professional services firms (Hill and Neeley, 1988; Lowendahl et al., 2001, Sonmez and Moorehouse, 2010).

The highly intangible nature of professional services and the level of buyer- seller interaction typically associated with them have given rise to challenges in specifying and comparing services both before and after purchase (Clark, 1995; Day and Barksdale, 2003; Perner et al., 2014).

Professional services therefore have high credence qualities (Darby and Karni, 1973; Dulleck and Kerschbauer, 2006; Bonroy 2013)) where the service cannot easily be assessed even after its completion. There is uncertainty for buyers as services might be provided in excess of actual need or poor quality services may be chosen over better quality services because value cannot be adequately assessed (Chaserant and Harnay, 2013). Sonmez and Moorehouse (2010), for example, concluded that “there is no doubt that the decision to purchase skills training is hard and challenging for managers like any other

professional services due to intangibility of services and subjective nature of such decisions” (Sonmez and Moorehouse, 2010, page 204) and for at least some organisations selecting professional service providers was “mainly based on “gut feelings” and subjective assessments” (Sonmez and Moorehouse, 2010, page 204). The difficulty of assessing certain services has also been called performance ambiguity, defined as occurring where any dimension of an exchange makes it difficult for either party to evaluate it (Bowen and Jones, 1996).

In addition to this uncertainty surrounding performance other uncertainties have also been identified in relation to consultancy procurement. These have included relational uncertainty (whilst sharing knowledge within and across industries is a core part of consulting, companies have concerns about whether their sensitive information may be shared with their competitors) and psychosocial uncertainty (essentially companies’ anxiety about involving unknown outsiders) (Bergholz, 1999; Perner and Werr, 2013).

### **Procuring professional services**

The review of supplier selection decisions for professional services identified four themes which relate to how buyers of professional services have been seen to respond to the challenges of supplier selection in this sector. These have been identified as summarised in Figure 4 and are considered thereafter.

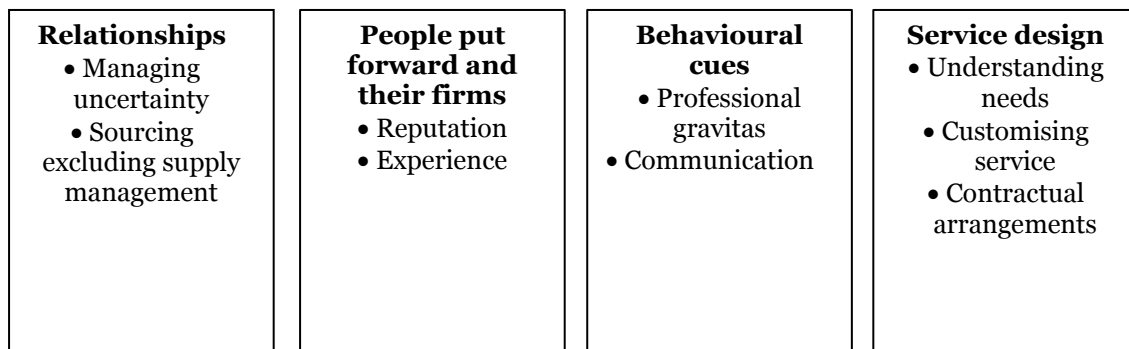


Figure 4: Themes from professional services selection literature

## Relationships

Recent research, especially into supplier selection in management consultancy (Werr and Perner, 2005, 2007; Sieweke, 2012; Perner and Werr 2013; Perner et al, 2014) has focussed on the procurement process and the role of procurement professionals. Buyers have been seen to manage the challenges of professional services procurement by relying on buyer – seller relationships typically, as noted above, with limited or no involvement of professional purchasing departments (Armbruster, 2006; Bals et al., 2009; Werr and Perner, 2007; Sieweke et al, 2012).

Services expenditure and marketing services expenditure in particular has also been seen to be managed very informally with low levels of professional procurement involvement (Bals et al., 2009; Ellram et al., 2007, Tate et al, 2010). This reliance on relationships can risk “overembeddedness” (Uzzi, 1997) where consulting arrangements persist with an existing supplier when there may be more beneficial opportunities with other suppliers that have not yet been used. Informal management of services procurement also provides little incentive for suppliers to improve their cost management (Tate et al, 2010).



More recently organisations have started to formalise their professional services procurement activities (Ogden et al., 2007; Werr and Perner, 2007) by introducing policies and special arrangements including preferred provider agreements (Perner and Werr, 2013) although the extent of formalisation has also varied across organisations (Perner et al., 2014; Sieweke et al., 2012). In relation to consulting services, different approaches have been identified. Some companies have adopted a decentralised approach where functional managers decide on whether to use consultants (Honer and Mohe, 2009; Werr and Perner, 2005), others have followed a more centralised approach involving procurement specialists selecting consultancies or supporting managers in contract negotiations (Werr and Perner, 2007). A hybrid approach may also occur involving elements of both (Werr and Perner, 2005). There is a challenge to formalising procurement when the purchase of knowledge intensive business services such as professional services is normally characterised by high levels of interaction and collaboration and problem solving in order to co-create value (Aarikka-Stenroos and Jaakkola, 2012).

The auditor selection decision also poses particular challenges to procurement professionals given its governing law and regulation. As set out in Chapter 1, the scope of work performed is governed by law and the auditors' professional judgement and is required to be taken by the Board based on a recommendation from the audit committee.

In addition to studies concerning the professional services procurement process other studies of supplier selection in this sector have also identified relationship influences of track record (Stock and Zinszer, 1987), experienced

based trust (Glucker and Armbruster ,2003; West, 1997)and accumulated knowledge (Dawes, 1992).

Appendix I summarises literature which has considered criteria affecting supplier selection decisions in professional services. In addition to relationship influences, three other influence groups are identified namely people put forward and their firms (competences and capabilities), behaviour and service design. These are now considered.

### **People put forward and their firms**

The second theme identified from the review of the professional services selection literature was assessment of the people put forward and their firms. This has included consideration of the reputations of the individuals in the teams competing for selection and their firms both generally and in the relevant specific functional area (Cagley, 1986; Dawes, 1992; Stock and Zinszer, 1987). Prior experience of the competing teams at an individual consultant level and at a firm level and including their relevant industry experience have been considered important (Dawes, 1992). In some cases prior experience has been directly relevant for example if services being provided were closely related to or integrated with those previously provided. For example; “advice concerning information technology often results in the purchase of complex computer and telecommunications equipment. “If a consultant is used to help an organisation purchase such equipment, then it is quite natural for that consultant to oversee its installation” (Dawes, 1992, page 189).

Studies also identified the influence of the quality of people being proposed more generally (Cagley 1986, West, 1997) and the conduct of personal assessments on key individuals (Somnnez and Moorehouse, 2010).

Size, age and location of the firm, and other consultants' recommendations have been found to be less important (Dawes, 1992) although having sufficient professionals to allow flexibility in delivery has been found to be influential (Somnez and Moorehouse, 2010).

### **Behavioural cues**

The third theme identified related to behavioural cues which were seen to be cues for quality, for example people seen to be behaving professionally were considered more likely to deliver a quality service (Stock and Zinszer, 1987), or where the gravitas and personal presentation of a trainer and ability to share real world experience and anecdotes were seen as supporting a better training solution (Sonmez and Moorehouse, 2010).

More generally firms demonstrating understanding of the clients' needs and having good interaction, and communication skills (Day and Barksdale, 1992) were also found to be important.

### **Service design**

The fourth theme incorporated considerations which are associated with how well the proposed service connected with the purchasing company such that its design most precisely met their needs. This includes understanding the client's needs (West, 1997), the ability of the provider to customise the solution

to the client's needs, to thinking and to bring added value (Somnez and Moorehouse, 2010) and agreement on goals and objectives (Cagley, 1986). Day and Barksdale (1992) also separately identify contractual and administrative conformance.

These studies also indicate an influence of competitive fees as a decision influence and added value (Dawes, 1992; Day and Barksdale, 1992; Glucker and Armbruster, 2003).

In summary therefore professional services are often strategically important, contain high degrees of knowledge, tend to be highly intangible and as a result, are difficult to assess before, and even after, completion. In response to the particular challenges of procuring such services pertinent literature shows companies using a range of factors for assessment which may be grouped into four themes. These include capability and competence assessment of the teams and their firms, relationships, behavioural cues as well as service design.

Sonmez and Moorhouse, (2010) found that factors related to reputation, organisational capability and costs were short-listing factors, or pre-qualifiers, whereas those related to competence, knowledge and understanding and the product (training solution) were final stage differentiators.

This section has considered professional services literature outside of statutory auditor services. The next section now focusses on that specifically.

## **2.6. Statutory audit services**

The nature and recent history of statutory audit services and the FTSE 350 audit market was discussed in some detail in Chapter 1. In this section therefore the focus is on what has been identified in academic literature relating to auditor selection within the overall category of professional services, restricting that review to decisions made by companies. As will be shown, there is a paucity of literature. For example this researcher is aware of no previous academic study devoted solely to FTSE 350 companies and no recent academic study of auditor selection in the United Kingdom. Given the different regulatory and cultural environments affecting auditor selection, overseas studies are likely to be informative, but not strictly applicable to the United Kingdom context.

Because of the low tendering and switching rates identified in Chapter 1, there has been some academic interest in auditor switching. Although the reasons for moving away from an auditor might not necessarily be the same as those for choosing a new one (Beattie and Fearnley , 1995), for the reasons set out below these studies have also been included as it is likely that they can provide further relevant insight.

In common with other professional services audit relationships have been found to be complicated and changing and the decision as to which auditor to appoint is likely therefore to be complex. “Because one of the main aspects of service marketing is the concept of intangibility, clients of accountancy firms may be expected to have difficulty in assessing complex services and the

associated proprietary methodologies or standardized methods of approach which are offered by such firms” (Scott and van der Walt, 1995, page 28).

The auditor selection literature suggests that this decision is likely to be influenced by characteristics of the company (these factors will determine the general size, class and/or industry specialisation of the audit firm selected (Beattie and Fearnley, 1998b) and by supply-side factors, (auditor characteristics which will also influence the specific audit firm chosen) and the auditing environment (Beattie and Fearnley, 1998b). The evolution of the auditing environment is discussed in Chapter 1. This section therefore now considers the influence of buying company and auditor characteristics.

### **Company characteristics and preferences for big firm auditors**

Unsurprisingly given the market and regulatory environment surrounding audit as explained in Chapter 1, much of the literature exploring the impact of company attributes on auditor choice has focussed on agency influences and especially their impact on assessment of audit quality. As noted in Chapter 1, agency is important in the choice of auditor given information asymmetries between management who run the business on a day to day basis and shareholders who own the company and profit or lose from its operation.

In theory, the quality of auditing ought to be homogenous across all audit firms because each has to comply with the same regulatory oversight and follow the same accounting standards. In practice however there is evidence from a number of studies and jurisdictions which shows that differing company specific attributes have influenced the auditor selection decision towards more specialist

or larger firms who are considered to provide greater audit quality. These are now considered in turn.

### **The constitution of company boards**

A greater proportion of independent (non-executive) directors working in active audit committees has been associated with the selection of industry specialist auditors (Abbott and Parker, 2000). Independent directors, it has been argued, are more likely to be focussed on audit quality because they are concerned with their own personal reputational risk. As people likely to have established reputations they are likely to be more concerned to avoid financial errors and misstatements. Industry specialist auditors are argued to provide best audit quality because, following this argument, they are more likely to detect and report financial statement errors and fraud and so the presence of directors with high personal reputational risk therefore influences the selection of auditors towards them (Abbott and Parker, 2000; 2001).

Companies with higher proportions of outside (or non-executive) directors have also been associated with the appointment of specialist industry auditors in specialised industries; again industry specialisation argued as a proxy for audit quality (Beasley and Petroni, 2001).

One limitation on the extent of the selection of industry specialist auditors and the likely resultant concentration of audits with a few industry specialist firms is a reluctance that has been identified on the part of companies to appoint the same auditor as their competitors in industries of high concentration (Kwon, 1996).

### **The composition of the shareholder group**

The presence of institutional shareholders has also been associated with companies with specialist industry auditors (Velury et al., 2003). Because institutional shareholders are argued to be actively interested in the quality of reporting in the financial statements of companies and empirical evidence supports an association of audit quality with quality of reporting (Velury et al., 2003), it is argued that better quality reporting enables institutional investors to monitor their investments more effectively. Industry specialism is again taken as a proxy for audit quality because industry specific experience enables auditors to identify and address industry specific issues more thoroughly than other auditors (Velury et al., 2003). The influence of institutional investors is underpinned by the greater numbers of shares that they hold and is manifest in a number of ways including negotiations with management and press relations (Velury et al., 2003).

The influence of block institutional shareholders was identified following the demise of Arthur Andersen. Companies with block shareholders were observed to be more likely to move to completely new auditors when Arthur Andersen collapsed rather than follow their previous audit teams into the firms taking over their audits (Blouin et al., 2007).

### **Information asymmetry**

The existence of information asymmetry in the shareholder/management relationship as outlined in Chapter 1, means that shareholders cannot accurately assess audit quality because of the limitations on the information made



available to them. Because of this, it has been argued that the appointment of a larger audit firm provides a signal to shareholders that management are expecting growth in future cash flows and therefore the value of the relevant company (Bar-Yoesef and Livnat, 1984); or that there is an underlying favourable story to tell which a higher quality auditor might expose more accurately (Titman and Trueman, 1986).

Agency costs arising from information asymmetry have also been seen to create a preference for bigger, “brand name” auditors in relation to new issues (Firth and Smith, 1992). The lower levels of shareholding by management following a listing and typically high debt levels have been seen to be associated with the appointment of a “brand name” auditor (then “Big 8”). A preference for big firms by listed companies in emerging markets (having greater perceived risk) has also been identified (Citron and Manalis, 2001; Timea et al., 2011).

Because users of financial information cannot directly observe audit quality it has been shown that they have relied on the reputations of the larger firms (Firth and Smith, 1992). The influence of auditor brand reputation on auditor selection was also supported by Francis and Wilson (1988) who identified that in seeking quality differentiated audits, brand rather than company size or agency costs explained the preference for big firms. Auditor reputation has also been identified as important for large companies generally (Hermanson et al., 1994).

As well as the presence of outside block shareholders referred to above, the propensity for companies with greater agency concerns to move was also

attributed to reputational issues and in particular a concern for the companies to be seen to have completely independent new auditors (Blouin et al., 2007). Following the demise of Arthur Andersen, companies with higher agency costs across a number of measures including size, complexity and levels of management share ownership tended to sever ties and move to completely new auditors whereas those with lower agency costs followed their previous Arthur Andersen partner thereby minimising the costs that would need to be incurred from switching auditor completely (Blouin et al., 2007).

### **The financial resources of the larger firms**

Lastly, it is argued that because larger firms have greater financial resources, the appointment of a larger firm provides a degree of insurance to shareholders because these larger firms can be held more financially accountable in the event of misstatements contributed to by their negligence (Bar-Yoesef and Livnat, 1984), especially given the unlimited liability of the auditor referred to in Chapter 1. This was also suggested by Oxera (2006) as a factor favouring the selection of Big 4 firms in the FTSE 350.

### **Conclusion on company characteristics and the resulting preference for big firms**

This section has shown that a number of attributes of companies have been identified which influence auditor selection; whether industry specialist, big firm or well-known brand. This helps to explain the concentration of FTSE 350 audits within the Big 4 audit firms noted in Chapter 1, and the price premiums achieved by big firms that have been observed in the United Kingdom

(for example; Ireland et al., 2002; Clatworthy et al., 2009). However because each of the Big 4 firms has substantial size and an established global network and reputation, these company attribute related influences appear to provide less evidence as to how companies choose *between* the Big 4 in the FTSE 350. Given, as shown in Section 1, that most tenders are won and lost by the Big 4, it is therefore likely that other factors will be more pertinent to decision making in this market, at least after composition of a shortlist. A closer look at other auditor choice literature therefore follows to seek to identify decision factors that have been seen to cause companies to choose between audit firms.

#### **Further auditor choice literature - the influence of audit firm attributes and approaches on auditor selection**

Evidence of the influence of the competing firm's attributes and their approaches on the auditor selection decision can be found in studies both of auditor switching and auditor choice.

The findings from research into auditor selection that has been conducted suggest a multidimensional assessment of auditors which is broadly consistent with the four themes identified for other professional services previously set out in Section 2.5. Figure 4 was set out in that section and has been modified below to include (in italics) further related items from the audit selection literature.

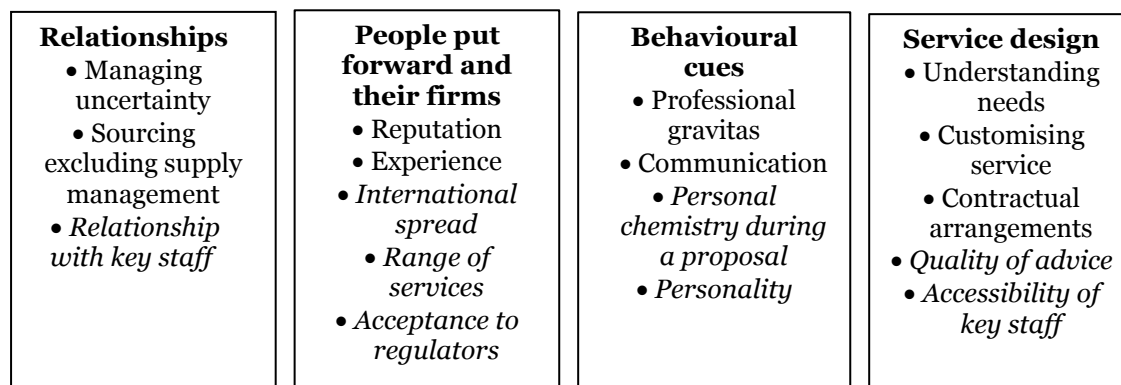


Figure 5: Themes identified from the statutory auditor selection literature

Appendix II summarises the specific auditor selection research concerning factors affecting selection decisions and this is now discussed below.

### **Relationships and past track record**

Although as Beattie and Fearnley (1995) observed, the reasons driving change (e.g. problems with the previous auditor) were not necessarily involved in the choice of a particular new auditor (see also Francis and Wilson, 1988), it would not seem unreasonable to assume that factors giving rise to a potential change (e.g. dissatisfaction) in an otherwise very stable market are likely to be relevant to a selection decision in at least some cases (e.g. removing the causes of that dissatisfaction). In choosing a new auditor, companies might reasonably be expected to seek to resolve the issues they had with their existing auditor or look to strengths or proposals from their new auditor to address weaknesses in their existing auditor and, if failings in relationships are seen to trigger consideration of change, then the existence of successful relationships elsewhere would be likely to be a decision influence.

The direct reference to relationships in the statutory auditor selection literature is limited, perhaps reflecting the questionnaire approach to the

research that most of the studies that have undertaken. This is returned to below.

### **Competence and capability**

In assessing audit firms, the importance of the competence and technical quality of the audit engagement staff has been highlighted along with industry specialisation, knowledge and expertise (Addams and Davis, 1994; Almer, 2014; Beattie and Fearnley, 1995; Sands and McPhail, 2003). In making comparisons of competence studies, have identified assessments being made at the client team and firm level (Beattie and Fearnley, 1995) and also that of the lead audit partner (Almer, 2014). Harmanson (1994) identifies more generally, personnel.

In addition to competence-based assessments capability measures have also been considered including international spread and capabilities of the audit firm, product range and broad range of services (Addams and Davis, 1994; Beattie and Fearnley, 1998; Scott and van der Walt, 1995). Similarly the quality of non- audit services has also been posited as a factor (Beattie and Fearnley, 1998). In contrast to competency assessments these capability considerations seem to be being made at the firm level. However this is an example of an area where the dynamics of the auditor selection decision are likely to have changed. As noted in Chapter 1, following Sarbanes-Oxley and the UK Combined Code there has been much more focus on the level of non-audit services delivered by auditors as a result of the potential risk this is argued to provide to auditor independence. Quality of non-audit services delivered by a firm might therefore more recently be a reason not to appoint that firm as auditor or at least the

range of services which companies may deem as being permissible for their auditors to supply is likely to be very restricted; potentially only to those services which may be considered related to the audit such as, for example certain audit work related to regulatory requirements.

The existence of an office located close to principal accounting functions and location of firms' offices and geographic proximity more generally have also been identified as influences (Addams and Davis, 1994; Beattie and Fearnley, 1995; Sands and McPhail, 2003). Although studies comment on the existence of an office close to companies' operations, it also seems relevant that the comparative strength of local offices ought also to be a factor.

Lastly, in relation to firms' resources, image and acceptability to a company's regulators have been identified (Beattie and Fearnley, 1995; Scott and van der walt, 1995); although as noted earlier in this section, in practice these may in many situations be short-listing factors rather than decision factors given the comparability of the major firms.

### **Behavioural influences**

In relation to behavioural influences, Addams and Davis (1994) found that the impact of personal relationships developed through the proposal process was the most important decision factor. Beattie and Fearnley (1998) identified the importance of personal chemistry and personality. They also acknowledged however that the determinants of personal chemistry were not readily identified and recommended more work in this area.

The influence of the interaction between audit firms and companies during tender processes has been largely ignored by other studies and, given the nature of FTSE 350 tender processes explained in Section 1, this could be an important extension of research

### **Service design**

Companies have been identified to be seeking audit quality in their auditor selection decisions (Baldacchino and Cardona, 2011; Beattie and Fearnley, 1995). Other aspects of the audit service identified as influences include guidance on accounting principles and quality of advice to management (Beattie and Fearnley, 1995; 1998a) along with the quality of working relationships (Beattie and Fearnley, 1995; 1998a; Eiechenseher and Shields, 1983).

People related service factors identified have also included client orientation (Sands and McPhail, 2003), accessibility of key staff (Scott and van der Walt, 1986), responsiveness (Eiechenseher and Shields, 1983) and availability of the auditor (Baldacchino and Cardona, 2011).

Value for money and fee have also been identified as factors affecting auditor choice (Eichensher and Shields, 1983; Beattie and Fearnley, 1995; Baldacchino and Cardona, 2011) although Beattie and Fearnley (1998a) found that fees were not significant influences on a decision except where they fell outside an acceptable range and that other factors were more important. This finding was recently supported by Almer (2014).

The auditor selection literature has been considered in this section and does provide additional insights to inform this research. However there are also important limitations affecting this body of research and before concluding the literature review these are therefore considered next.

### **Limitations of the auditor selection literature**

As noted above, whilst the extant literature does provide some insight into auditor selection, there are also important limitations within it which affect its relevance to this study.

Firstly most of the studies have involved questionnaire based surveys. Whilst this has enabled responses to specific questions to be identified, it provides little evidence as to what influences are in play as decisions are arrived at and how they might evolve during a process.

Also, many of these studies have included companies who have never conducted an audit tender and so they are hypothesising about what would happen *should* they do so. Respondents have also been asked to select priorities from a list, but in some cases the rationale for that list is unclear introducing the risk that the factors sampled might miss other important influences.

Thirdly, and as illustrated in Appendix II, these studies have been undertaken in a number of different populations and jurisdictions. Whilst it can be worthwhile to consider a number of different perspectives, auditor choice may well be different given the different pertaining cultural and regulatory



environments and especially between different market segments (private, smaller public and larger public companies).

Fourthly, the empirical research in the United Kingdom predates much of the regulatory and market activity summarised in Section 1 and in particular, the Enron scandal, the collapse of Arthur Andersen, developments in the regulatory environment and the significant focus on the roles and responsibilities of audit committees that followed.

## **2.6. Conclusion: supplier selection literature and the FTSE 350 context**

Following the identification of a paucity of literature specifically focussing on auditor selection this literature review has taken an exploratory approach as summarised in Figure 4, reviewing literature in relation to supplier selection more generally and that concerning decision theory and other related literature.

The review of supplier selection literature identified numerous studies concerning the supply of goods. The evolution of supplier selection as more collaborative approaches and strategic partnerships was discussed. Most of the traditional supplier selection studies tended to be based implicitly or explicitly on normative economic models.

The review has however identified a number of challenges to traditional goods based supplier selection models and their underpinning normative rational economics:

- The chapter has identified literature which suggests that services are inherently different from goods because they are intangible, heterogeneous, are characterised by the production and the service being inseparable and perishable (in the sense that they can't be stored such that a service not supplied can be a service lost). As a result the procurement process does not operate in the same way.



Figure 6: Summary of the approach taken to the literature review

- Criticism of normative models based on factor optimisation has also been identified from those who argue that value has to be customer specific and co-developed. In an environment where competent suppliers and involved buyers co-create value standardisation would be impossible.

- Studies have also criticised the rational economic theory underpinning traditional normative models. In particular behavioural decision theory strongly suggests that human decision making does not follow rational economic norms. In any decision involving complexity there are likely to be too many variables and insufficient information to meet the requirements for perfect information. People therefore “satisfice” and demonstrate systemic bias; often falling back on past experience. This behavioural decision literature also suggests that many decisions, especially those taken under uncertainty, are unlikely to be wholly or mainly based on pure rational economic models. Given the uncertain and intangible nature of auditor selection explained in Chapter 1, these behavioural influences are likely to be relevant to the auditor selection decision.
- In situations of uncertainty people also fall back on relationships and their decision making is also therefore likely to be affected by the relationships they have, the trust they place in people and the loyalty they feel. There is considerable literature supporting the influences of relationships in buying and selling. The importance of trust in the audit relationship, given the special rights of the auditor which was explained in Chapter 1, appears to be of particular interest. As has been shown, however, there is some doubt as to whether trust is a short-listing factor; necessary to have a chance of selection or a final decision criterion. The literature also suggests that loyalty can also be a powerful influence on

buying although a number of limitations and conditions have also been identified.

- In addition decision makers' behaviour is likely to be influenced by the groups, organisations and networks that they operate within. There is strong evidence of the influence of groups on behaviour generally, also of a number of ways in which groups interact in making decisions. The structure of a typical audit selection panel was discussed in Chapter 1 where it was explained that decisions tend to be made by selection groups of senior management and non-executives of companies representing different roles and working relationships with the auditors. The dynamics of groups are therefore also likely to be relevant to the auditor selection decision. But it is not only likely that decisions will be influenced by the interaction that takes place within a selection panel. In Chapter 1, Section 1.4 the high degree of connectivity between directors across the FTSE 350 was discussed and how word of mouth has been seen to influence decision making was considered next.

This completes the review of the relevant literature. It has identified a number of potential themes in relation to factors which may be affecting auditor selection but no comprehensive overall model and no recent research within the UK.

The auditor selection decision sits within this overall complexity and it is against this backdrop that the auditor selection decision is being taken. This research seeks to extend our understanding of that selection process by

conducting a holistic study of the influences at play in the auditor selection decisions of FTSE 350 companies.

The research question to be answered by this study is therefore:

*What are the factors affecting the auditor selection decisions of FTSE 350 companies in competitive tenders?*

The next chapter sets out the research methodology adopted in order to answer that question.

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## CHAPTER THREE

### METHODOLOGY

#### 3. Introduction

This section considers the research philosophy, strategy and design and sets out the reasons for adopting a qualitative, constructivist methodological approach. It also explains the data collection method and the analysis techniques used.

A summary of the overall research approach is set out in Figure 7 and is explained in the sections that follow.

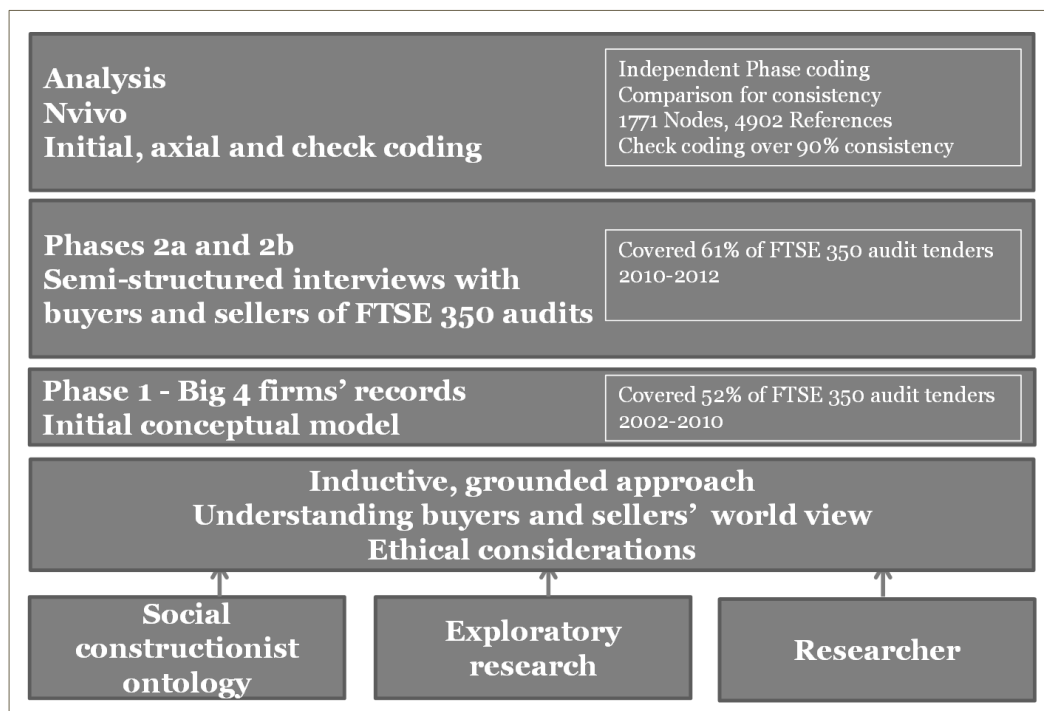


Figure 7: Summary of the research approach

The paucity of research into professional services supplier selection and in particular auditor selection within that sector was discussed in Section 2.5. Due to this paucity of research there is a need for exploratory research to understand the factors influencing the auditor selection decision and how interaction between these factors contributes to auditor selection outcomes. Chapter 2 identified economic and behavioural influences that influence or ought (according to normative economic models of supplier selection) to influence buying decisions. Although there is extensive literature in relation to supplier selection (especially as it relates to goods) and also in relation to behavioural and relationship influences on purchasing and relationship management, there is very little empirical research as to how these varied influences may be interacting and influencing professional services supplier selection. This provides further support for an investigative approach.

By exploring the auditor selection decision from the viewpoint of those who have been closely involved in auditor selection processes, both as buyers and sellers of statutory external audit services in the UK's largest companies (the FTSE 350); this research aims to answer the question of how the various factors considered by them are influencing the auditor selection decision. The research is based on data obtained from semi structured interviews and interview records covering a ten year period from the acquisition of the UK practice of Arthur Andersen by Deloitte in August 2002 to issuance by the Financial Reporting Council of the revision of the UK Corporate Governance Code with effect from 1 October 2012.



Consistent with its exploratory and investigative nature, the research is inductive in design and aimed at gaining greater understanding of the selection decision from the perspective of the purchasers and sellers of statutory audits. The research is based on qualitative interviews which attempt “to understand the world from the subjects’ point of view, to unfold the meaning of their experiences, to uncover their lived world prior to scientific explanations (Kvale and Brinkman, 2009, page 1)”. It uses a grounded approach (Glaser and Strauss, 1967) to explore emergent theory whereby the ideas and concepts flow from the data rather than being used to challenge or support existing theoretical models and hypotheses. This inductive design and constructionist approach enables the examination of relationships and emerging themes building from initial coding.

This chapter has four sub-sections. The first sub-section considers the research philosophy comprising the ontological and epistemological assumptions underpinning the qualitative and interpretive approach adopted. The second sub-section sets out the research strategy and explains why it is consistent with the underlying philosophical assumptions adopted. The third sub-section then considers the data collection methods adopted and the analyses approach and tools used. Lastly this chapter considers ethical matters relevant to the study.

### **3.1. Research philosophy and design**

The philosophy of the research is important because it informs the research design, how the data will be collected, the method of analysis and how the knowledge will be gained. The acceptance of a particular epistemology

usually leads to a researcher adopting methods consistent with that position (Easterby-Smith et al. 2002). This section therefore explains the philosophical position of the research; in particular the ontological and epistemological positions which underpin it.

### **3.1.1. Ontology and epistemology**

Ontology is concerned with the nature of what exists. In social sciences this has been interpreted as concern with the nature of social reality (Blaikie, 2007). An epistemology is a theory of knowledge. It is a theory of how we know what we know. It provides the philosophical grounding for establishing what can be known. In social sciences it has been interpreted as a concern with how social reality can be known (Blaikie, 2007).

The philosophical debate in social science about how research should be conducted has often been framed on a range between two extreme traditions. These two extremes are positivism and social constructionism (Easterby-Smith et al., 2002).

The ontological assumption underpinning positivism is that reality is external and objective. Its underlying epistemological assumption is that knowledge can only be of significance if it is based on observations of this external reality (Easterby-Smith et al., 2002). Positivists argue that the social world exists externally and that its properties should be measured through objective measures rather than being inferred subjectively through sensation, reflection and intuition (Easterby-Smith et al., 2002). At the extreme of objective approaches the social world is seen as a hard concrete real thing “out

there” which affects everyone. Reality is an objective phenomenon that lends itself to accurate observation and measurement. The researcher’s role is to discover the meaning that already exists in “things” (Blaikie, 2007). Any aspect of the world that cannot be observed in an activity or behaviour is regarded as being questionable (Morgan and Smircich, 1980). Within this paradigm human beings are viewed as the product of external forces and as conditioned by the stimuli in their environment (Morgan and Smircich, 1980). Positivism has been generally associated with quantitative research methods where theory is tested by developing hypotheses prior to data collection.

Next sits realism which asserts the existence of some kind of reality and for social sciences is concerned with the nature of reality and where it can be found (Blaikie, 2007). Within realism a number of different ontologies have developed including shallow or naive realism (Bhaskar, 1979) (which argues that all that exists is what we can see) conceptual realism (Blaikie, 2007), (which argues that whilst there is an existence independent of human minds it can only be known through the use of the innate human capacity for thought and reason) and depth realism (Bhaskar, 1978). Depth realists argue that reality exists in three domains: the empirical domain which represents our experience through our senses, the actual domain which includes events that occur whether anyone is there to see them or not and the real domain where the processes that generate events are located (Bhaskar, 1978).

At the opposite end of the range to positivism sits social constructionism (Berger and Luckman, 1966) which focuses on the way that people make sense of their world; especially through sharing their experiences with others through

language (Easterby-Smith et al., 2002). Social constructionists argue that “reality” is not objective or exterior but rather is socially constructed and given meaning by people. The researcher plays an active role in the creation of meaning from “things” (Blaikie, 2007). “The social world is a continuous process, created afresh in each encounter of everyday life as individuals impose themselves on their world to establish a realm of meaningful definition” (Morgan and Smircich, 1980, page 494). “Knowledge arises through acting and interacting of self –reflective beings” (Corbin and Strauss, 2008). Social constructionism is generally connected with qualitative approaches where theory is built through interpretation of data collected.

Across the range of ontological and epistemological positions there are many other alternative philosophical positions. Understanding the philosophical alternatives is important to enable the researcher to make ontological and epistemological choices which are clear and consistent with the research methods adopted.

### **3.1.2. The chosen research philosophy**

The research philosophy selected followed consideration of the various ontological paradigms, the researchers own philosophical position, and had regard to the gaps left by the approaches taken by most of the auditor selection studies (and numerous supplier selection studies more generally) which have generally adopted a positivist largely quantitative approach. To fit with these considerations and to address these gaps, the current research therefore adopts

the ontological paradigm of social constructionism which is one of a number of interpretive approaches (Habermas, 1970).

Studies based on an ontology of social constructionism aim to increase understanding of a situation by gathering rich data from which ideas are induced. Having regard to human interest and stakeholder perspectives they are generalised by theoretical abstraction. This approach is consistent with the exploratory and investigatory nature of the proposed research which is aimed at understanding the influences on the auditor selection decision from the viewpoint of those involved in that decision. The research adopts an interpretivist epistemology to investigate how people make sense of the decision.

As noted above, much of the previous research into auditor selection and supplier selection more generally has traditionally taken a deductive approach based on a positivist ontology which assumes a reality independent of those involved. An alternative grounded approach has been adopted to explore what the actors felt was important and how they experienced the auditor selection process.

The implication of this approach is that the researcher argues that there is no independent reality “out there” and the “reality” of an auditor selection decision is constructed by those involved based on the influences and interactions which shape their views.

The qualitative, grounded approach (see further below) adopted is consistent with the underlying ontological and epistemological assumptions, the

research question, the exploratory nature of the research being undertaken and the complexity of the influences on the auditor selection decision.

### **3.1.3. The justification for a grounded approach**

The study adopts a grounded approach which is adapted from grounded theory (Glaser and Strauss, 1965; 1967). Grounded theory challenged the deductive approaches which were predominant in the United States in the mid twentieth century (Charmaz, 2012). The deductive scientific approach argued that research could only be valid if based on replicable experiments, operational definitions of concepts, logically deduced hypotheses and confirmed evidence (Charmaz, 2012); supporting this approach is a prerequisite that the researcher is independent of the research.

Glaser and Strauss shifted the emphasis from testing theories to their generation. They argued that good theory was systematically discovered from and verified with the data of social research (Blaikie, 2010). Furthermore they advocated an inductive process whereby theory generation is intimately involved in the process of research rather than distinct and separate from it (Blaikie, 2010). The components of grounded theory include simultaneous involvement in data collection and analysis, constructing analytic codes and categories from data rather than preconceived logically deduced hypotheses, constant comparisons during each stage of the analysis, advancing theory development during each stage of data collection and analysis, memo writing to elaborate categories, define relationships between categories and identify gaps, sampling aimed at theory construction rather than population

representativeness and conducting the literature review after developing independent analysis (Charmaz, 2012).

Given the exploratory nature of the current research, the complexity and intangibility surrounding auditor selection described in Chapter 1 and the lack of existing theory in professional services supplier selection explained in Chapter 2, grounded theory provides a systematic and proven approach to support the generation of theory in this study. Moreover grounded theory, accepting the complex nature of organisational life (Glaser, 1992; Heath and Cowley, 2004), is consistent with the social constructionist ontological and interpretivist epistemological position adopted for the study as explained earlier in this chapter.

The approach advocated by grounded theory has however been adapted for this study principally in two ways. Firstly grounded theory as originally espoused, proposes limited prior knowledge of the research area. This is important so as to avoid contamination of the data which may occur as a result of any preconceptions the researcher may bring to the study (Pettigrew and Fenton, 2000). In this study however the researcher's business development position and experience working in the auditing profession would inevitably preclude an approach based on grounded theory as it was originally proposed and defended by Glaser (1992). Secondly, and similarly the literature review was not conducted after the completion of the research but rather before and during it providing further risks of contamination if measured against grounded theory as proposed by Glaser (1992). Strauss however has suggested that some researcher knowledge and experience or depth of reading before collecting data

is both beneficial to theory development and unavoidable (Strauss and Corbin, 1998; Heath and Cowley, 2004; Speakman, 2008).

In this study the Researcher's own knowledge and current experience of working as a qualified chartered accountant for a Big 4 firm was important to the study. It enabled access to a rich pool of data (as will be further explained below) and, as also further explained below, facilitated access to those involved in a large proportion of auditor selection decisions during a key part of the research. Importantly and consistent with Beattie and Fearnley (1995), it enabled a relationship of trust to be established with those involved in the study because of the confidentiality assurance and the common professional ground which existed because both researcher and most of those researched were qualified accountants.

In relation to this study therefore, although the assumptions of grounded theory design are not inherent in the research, the organisation of the data collection and analysis are heavily influenced by it. In addition the principles of grounded theory have also been used as a basis of the methods used to uncover emergent theory.

A grounded approach consists of systematic data collection and analysis in order to construct theory which is grounded in the data itself (Charmaz, 2006). In this study the grounded approach is taken whereby emergent theory in relation to the auditor selection decisions taken by FTSE 350 companies is grounded in the accounts of those involved in the decision. It is important that no prior hypothesis was developed. This approach follows and is consistent with



grounded theory where the aim is to conduct research with few or no preconceptions or hypotheses and allow emergent themes in the research to shape development of theory through a series of coding and reflection stages (Spiggle, 1994; Speakman, 2008). This grounded approach fits most closely with the later work of Straus and Corbin (1990;1998) where data analysis is bound by the preconceived themes identified through prior knowledge and literature review (Charmaz 2006; Easterby -Smith et al., 2002).

### **3.2. Research methods**

To address the research question of how FTSE350 companies make their auditor selection decisions in competitive proposals, the study captured the views of those involved in auditor selection. Since, as shown in Section 1.4.2, auditor changes have been until recently comparatively rare, the study examined post-decision interviews and records of such interviews, with FTSE350 companies for a ten-year period from August 2002 (the acquisition of Andersen by Deloitte, the last major consolidation in the UK FTSE 350 audit market) until the end of September 2012.

#### **3.2.1. Identifying the research population**

The researcher worked with one of the 'Big 4' audit firms and the population was initially identified in three stages. Firstly the firm's internal proposals records were reviewed and checked against the lists of FTSE 350 constituents published quarterly by the Financial Times to identify proposals performed by companies whilst in the FTSE 350. Secondly those lists of FTSE 350 constituent companies were further reviewed for evidence of an auditor

change (or “switch”) and where a switch was present the companies’ accounts were reviewed to identify whether or not that switch involved a proposal which may not have included the firm. Lastly, the accounts and other stock exchange announcements, where relevant, of those companies in the index at any quarter during the last two years of the period were reviewed for evidence of any proposal. As noted in Chapter 1, there may be omissions where both no disclosures were made of a tender in the company’s annual report and the Big 4 firm had no record, but the numbers of these exceptions is likely to be small. Companies’ annual reports disclose the name of the company’s auditor so any auditor switches can be easily identified. In addition, even where there had been no change, companies’ annual reports also include details of corporate governance and other audit committee activity. It would be unusual for a company to undertake a tender and not explain that they had done so. The tender would normally be considered to be part of the corporate governance activity undertaken by the company and overseen by the audit committee and therefore also be disclosed in the annual report.

Also as noted in Chapter 1, during the research period the firm subsequently submitted details of audit tenders to the Competition Commission. This process involved significant further investigation and consultation internally and cross referencing to external databases. The population initially identified was reconciled to that submission with only two additional tenders in the research period being identified.

### 3.2.2. Achieving the research sample

The research attempted to consider as many of the auditor selection decisions from competitive tenders identified in the population as possible and covered situations where the incumbent auditor was retained as well as those where an auditor switch occurred. As set out in Table 12 below, it proved possible to consider 60 auditor selection decisions in competitive proposals.

Research Phase (as set out above)	Decision Period	Population Total	Decisions sample		Total	Coverage %
			Auditor switches	Auditor retentions		
• Phase 1 data analysis	August 2002 to May 2010	83	34	9	43	52
• Phase 2 In depth interviews of which: <i>Company only (2a)</i> <i>Company and Big 4 firm partner(2b)</i>	Mid 2010 to September 2012	28	12	5	17	61
			4	1	5	
			8	4	12	
<b>Total</b>		<b>111</b>	<b>46</b>	<b>14</b>	<b>60</b>	<b>54</b>

Table 12: Summary of the research sample

Having obtained consent from the Big 4 firm, for the first 8 years of the study period (“Phase 1”), the firm’s post proposal interview records were examined. It proved possible to obtain post tender decision interview records for 43 of 83 decisions (52%) taken in that period

For the most recent two years of the study period (“Phase 2”) 17 of the 28 decisions (61%) taken in that period were examined in greater detail including in depth interviews regarding a specific auditor appointment covering the companies selecting auditors (the FTSE350 decision makers) and, where the Big

4 firm was involved in those tenders, also the key partners in the audit firm involved in the tender.

In total, therefore, the 60 tenders considered by the research covered some 54% of the 111 total tender population identified as having been undertaken over the approximately ten year period.

### **3.2.3. Data gathering**

The next two subsections set out the data gathering process. Phase 1 was based on the pre-existing post auditor selection decision records maintained by the Big 4 firm. Phase 2 was then based on semi structured interviews conducted under research conditions.

#### **Phase 1: Review of professional firm's interview records August 2002 to May 2010**

The firm's feedback from tenders normally involves an interview with at least one member of the selection committee conducted by someone independent of the tendering team; typically a senior partner of that firm or a senior member of the business development team. Interview results are documented in notes prepared at the time; sometimes the notes of more than one interview are collated for any one decision. 66 interview notes were obtained covering the 43 tender decisions identified above. Each interview typically lasts one hour so some 66 hours of interview material was considered. In each case the interview record contained an outline of the reasons companies gave for their selection decision, although in some cases the notes were quite

short and they provided a less rich picture than others. The interview records also of course could only relate to the tenders that the firm was involved in. The sample selected however included interviews only with those actively involved in a recent FTSE 350 auditor selection decision at the time of the interview and therefore included only those with recent experience of being involved in such a decision. It was thus a highly purposive sample. The later phases of this research also included tenders that the firm was not involved with and were recorded and subscribed (or in a small number recorded with cross checked notes). These later phases are considered next.

**Phase 2: In depth semi structured interviews June 2010 to July 2012**

Where a tender was identified in this period a semi structured interview with at least one person involved in the selection process was conducted as soon as possible after the tender's completion. Those interviewed included company executive management and non-executive directors from the companies' audit committees. As noted above it proved possible to conduct these company interviews in relation to 17 decisions or 61% of the 28 proposals identified. In total 23 interviews were conducted covering tenders both that the Big 4 firm was involved in and those it was not.

Because the firm was involved in 12 of the 17 decisions examined in these cases, an interview was also conducted with one or more partners on the tendering team. These interviews covered 43% of the total 28 proposals identified. The total number of partner interviews conducted was 24.

In total 47 interviews were therefore conducted in the two parts of Phase 2. Each of these interviews was again typically an hour in length, so some 47 hours of interview material was collected. This meant that well over 100 hours of interview material was included in the study as a whole when Phases 1 and 2 are taken together.

### **The selection of the semi structured interview for Phase 2**

The semi structured interview technique was selected for Phase 2 as it was considered to meet most closely the objectives of the research and was consistent with both previously successful research into auditor selection. Beattie and Fearnley, 1998a, page 77) commented that a semi structured interview “enables interviewees to provide responses in their own terms and in the way that they think and use language. The semi structured interview approach also serves to focus on understanding the dynamics present within single settings” and with industry practice for audit post tender reviews.

Kvale (1983) defines the qualitative research interview as “an interview, whose purpose is to gather descriptions of the life-world of the interviewee with respect to interpretation of the meaning of the described phenomena” (page 174). The aim is to focus on “specific situations and action sequences in the world of the interviewee” (Kvale, 1983, page 176). A qualitative interview approach is consistent with the research objective of understanding the auditor selection decision from the worldview of those who had been involved in it. The use of semi-structured structured interview techniques also facilitates the

gathering of richer and more insightful data and facilitates comparison between interviews conducted with different interviewees (Bryman 2001; Rowley, 2011)

Furthermore the semi structured interview has been considered the most appropriate for social construction of situated accounts (Qu and Dumay, 2011) where “social phenomena do not exist independently of people’s understandings of them and that those understandings play a crucial generative role” (Hammersley, 2007, page 297). The method is therefore consistent with the underlying philosophical position taken by the study. Semi-structured interviews also help develop understanding of the ways in which managers make sense of their jobs and their environment and create meaning from them. The issue becomes how to get inside the life world of managers so that the researcher is able to interpret this life world from within (Schwartzmann, 1993).

### **The semi-structured interview protocol and approach**

A semi-structured interview protocol was developed which was designed to enable the interviewees to explain the auditor selection decision from their viewpoint. The protocol also included prompts to explore the five themes identified from the literature review. These themes were capabilities and competences, relationships, the degree to which proposals were tailored to their needs, the behaviour of the firms during the process, and decision making. This helped to provide a frame for the discussion although in practice interviews flowed naturally as a conversation about the tender process and the decision as it progressed from initiation to final decision. The protocol also contained a prompt at the end to ask the interviewees to reflect upon what had been

discussed and to think about whether there were other matters that they considered may have been relevant to the decision.

The protocol was tested in the first three interviews before being reviewed. This review confirmed the interview protocol was working satisfactorily. A copy of the final interview protocol is set out in Appendix III.

Each interview was conducted with a consistent approach which included an initial briefing about the purpose of the interview and an expression of interest to hear about events as the interviewees saw them. Interviews were then conducted initially using open questions to encourage interviewees to talk through the audit selection decision process from the start and including how the final decision was made and including events or interactions that took place during the tender that the interviewee felt was important. After these introductory questions a range of questioning techniques was adopted consistent with Kavle and Brinkman (2009) including:

- Follow up questions to encourage interviewees to extend their answers and including verbal cues such as “mm” and non verbal cues such as nods of recognition.
- Probing questions to explore matters raised in more depth.
- Specifying questions aimed at gaining a more precise understanding of what was being said.
- Direct questions to clarify comments made.
- Indirect questions to explore the interviewees views on how others were feeling or viewing things.



- Structuring questions to move the conversation along.
- Silence to enable interviewees to reflect and develop their thinking.
- Interpreting questions to confirm understanding of meaning in what was being said.

Of the 23 company interviews conducted 16 were digitally recorded and transcribed. In each case where the interview was not recorded (typically due to concerns about commercial confidentiality) a senior executive from the firm who was not on the client bidding team was also present at the interview with this researcher and, following the interview, notes were prepared independently and then discussed to agree what was actually said. A similar approach was taken for the partner interviews where 21 out of 24 were digitally recorded and transcribed.

To illustrate the approach and by way of example, a transcript of one of the Phase 2a interviews (with names anonymised) is set out in Appendix IV.

Both company and partner interviews (with one exception) were conducted at the interviewee's offices either in their own office or in a meeting room or boardroom to help ensure that the content of the conversation was confidential to those involved and interviewees felt at ease.

#### **3.2.4. Data analysis**

Interview notes for both phases were coded using Nvivo 9 and adopting an initial coding and a splitting approach (Saldana, 2009). Coding adopted a grounded research approach with no pre-coding any data. Codes were also

employed with simultaneous coding where data was considered relevant to more than one node (Saldana, 2009).

Before concluding initial coding, the original code assignments and descriptions were reviewed to ensure that the code description fairly reflected the coded data and that the coded data were sufficiently consistent within the node. This resulted in some changes to a number of node names and recoding to ensure that the nodes really did fairly reflect the underlying data. There was also further splitting of a small number of codes. In particular nodes for meetings during the process, proposal documents and presentations were split to identify the individual elements within which were mentioned in the data.

Appendix V shows a screenshot (redacted to preserve confidentiality) of the initial coding that was applied to one part of the interview transcript example set out in Appendix IV, namely as it related to certain comments made about the company's relationship with its incumbent auditor. The initial coding and consolidating axial codes applied are shown in the coding stripes. These axial codes were created using the process set out next.

The second cycle coding process was undertaken to develop a sense of categorical, thematic and conceptual organisation from the first cycle codes (Saldana, 2009). Initial coding had identified a large number of factors and some potential groupings. During second cycle the number and description of nodes was then subject to a process of reflection, exploring tentative groupings and relationships through the use of manual spider diagrams. Building on the initial coding, axial coding was employed to reassemble data that were "split"

during the initial coding process (Strauss and Corbin, 1998, p124). The axial codes were reviewed extensively and some reassignment of individual nodes between these codes. Some nodes were also merged with others where it was apparent that the data they included related to the same issue as other nodes.

An example of part of the coding framework is set out Appendix VI. This contains that coding previously illustrated in Appendix V. The audit trail here is therefore from the transcript (where on pages 472-473 of this thesis the original comment about dissatisfaction was recorded), to the initial and axial coding illustrated in Appendix V through to the coding framework shown in Appendix VI. The codes identified in Appendix VI and the underlying text coded then support the narrative set out in findings (the relevant section is 5.2.1).

Coding was recorded in three independent Nvivo files for Phase 1 and each of the company and partners analysis for Phase 2. As Phase 1 was completed first this enabled the development of a conceptual model which was revised and developed during Phase 2. This approach also facilitated the independent analysis of each phase (and group within Phase 2) to ensure that the analysis was true to the data in that group and any differences between the phases (and groups) could be easily identified. Having said that, ex post comparisons were made across the phases to ensure that coding was using a consistent approach for the same underlying references.

Once complete the initial coding gave rise to some 1800 nodes in total across the two phases. Whilst the Phase 1 interviews were less detailed and not always completed using the probing techniques later developed, they did

nonetheless provide a large data set that which formed the basis for the initial conceptual model. This in turn then informed the construction of the more detailed interview protocol explained above which was designed to probe more deeply.

In some cases references were assigned to more than one node because the comments identified were relevant to more than one issue. In a number of cases the interpretation was challenging due to some ambiguity in the notes. For example, perhaps the most challenging area in the interpretation of data was in separating competence (the skills and competences that audit firms and teams had) from approach. For example in one interview a comment was made that one firm fell well short of the top two and on one technical area was a long way adrift. It would have been possible to attribute this comment either to a lack of resources in a particular area or a shortcoming in the proposed approach. When these cases occurred careful consideration was given to the content in the surrounding interview notes and the overall situation pertaining to that proposal as set out in the interview notes before deciding upon the most appropriate existing node or setting up a new one.

The second cycle coding then involved reflection and exploring groupings and relationships as explained above. This second stage coding also drew on the themes that had been emerging from the contextual considerations explored in Chapter 1 and the themes which had been discussed in Chapter 2.

During the coding process a number of factors emerged quite naturally. These factors contained other nodes where individual or smaller groups of matters identified in the interview records had been captured. The second phase of coding was then completed using both reflections from context and literature and the formative factors to create factor groups influencing auditor selection as shown in Figure 7.

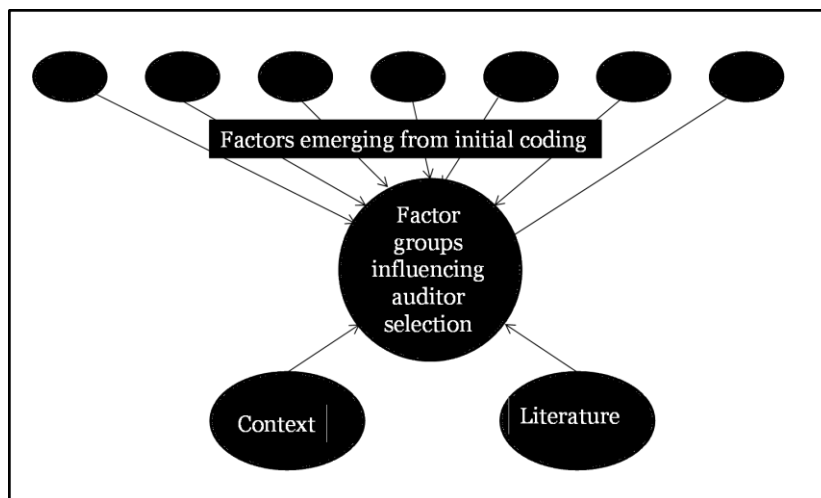


Figure 8: Developing the factor groups influencing auditor selection

As noted above, the initial coding phase included examples of assigning interview record content to more than one node. Having completed second stage, axial coding it was apparent that there were examples which included connections across the five factor groups influencing auditor selection (for example where a past incumbent relationship had been impacted by the way that an audit firm had dealt with a technical accounting issue), within factor group (for example where an audit firm's thorough preparation for meetings was connected with their understanding of the business), or simply because one paragraph of interview documentation contained unconnected content that was mentioned in the same paragraph of the interview notes and the whole

paragraph had been coded to all the relevant nodes so as to facilitate subsequent axial coding based on an understanding of the context of the comment. The issue of connections between factor groups is returned to under results.

Phase 1 axial coding culminated in a number of factors which represented related decision influences. This is explained further in Chapter 4. The factors identified were further placed within five factor groups influencing auditor selection and these are also explained below under findings. The process of axial coding took place over a number of months as coding was reviewed to ensure that the individual nodes were accurately coded to subcategories that fairly reflected the substance of the comments contained in the interview records. Although there was a rich range of individual stories, the overall factor groups identified proved to be consistent between all three independent analyses: Phase 1, Phase 2 company interviews and Phase 2 partner interviews and aligned to the literature as the research progressed.

For each of Phases 2a and 2b, one interview was check coded by a researcher independent of the study. The results of the check coding were compared with the original coding. The check coder was provided only with the overall background to the study and the two interview transcripts. The coding framework and coding was not shared in advance, making this a challenging test of the coding. On the first pass, there were some differences in terminology between the original coding and the check coding. For example one of the factor groups influencing auditor selection identified was behavioural influences during the tender process. The check coding had identified this as “Process Influences”. A detailed discussion followed the check coding during which the

coding framework originally used was discussed with the check coder. The purpose of this discussion and related reflection was to confirm whether differences identified were solely terminological or indicative of underlying problems in the original coding. During the course of this process the check coder confirmed that had they had access to the coding framework prior to check coding they would have used those codes. In other words the differences were overwhelmingly minor differences of terminology. Aside from these differences of terminology the check coding was consistent with the original coding with only a few minor differences representing less than 10 per cent of the check codes.

### **3.2.5. Ethical considerations**

Ethical considerations are important to interview based research because of the nature of the interaction between the interviewer and interviewee “researching private lives and placing accounts in the public arena” (Birch et al., 2002, page 1). As a result researchers conducting qualitative research should observe high ethical standards. This research was conducted having been approved by Cranfield’s ethical standards.

Four fields of ethical uncertainty have been identified in connection with interview research which are normally addressed by ethical guidelines (Kvale and Brinkman, 2009). These are informed consent, confidentiality, consequences and the role of the researcher. How each of these related to the research and the actions taken to maintain the highest ethical standards is now explored in turn.

### **Informed consent**

Informed consent involves informing the research participants about the overall purpose of the study and the main features of the design. It also entails communicating any risks and potential benefits involved in participating in the study (Kvale and Brinkman, 2009).

For this study the interviews were arranged in slightly different ways depending upon the research participant. For Phase 1 consent to use the data was obtained from management of the Big 4 firm and, as for other interviews, references to interview records remained unattributable.

For Phase 2 three different processes were used to obtain informed consent from research participants:

Where the Big 4 firm had participated in the tender, interview arrangements were facilitated with company officials by partners and staff at the Big 4 firm who had been involved in the tender. In these cases the interview also formed part of the firm's proposal post decision review process as described. In every case however the researcher informed interviewees of the intention to include the interviews within the research either in a written communication prior to the meeting or at the interview. Research participants were given the opportunity to decline an interview or accept the interview but restrict its purpose solely for the Big 4 firms' post decision review process. In all but one case research participants consented to inclusion of the interview material in the research. In one case the interviewee confirmed that they were happy to conduct an interview but solely for the purposes of the Big 4 firm's post decision



review process. In this case the interview was conducted for the Big 4 firm but the results were excluded entirely from the study.

For interviews with the Big 4 firm's partners, interviews were organised directly and consent was obtained directly prior to the interview.

Where the Big 4 firm was not involved in the tender, interviews were facilitated through partners with other business relationships with the research participants. In these cases consent was obtained at the interview. In these cases interview participants were given the opportunity to restrict the use of interview material to solely for the purposes of the research and not to provide any information back to the Big 4 firm. In these cases their preferences were respected in every case.

In summary therefore informed consent was obtained for the use of the Big 4 firm's data from that firm's management prior to Phase 1 and from each research participant prior to each interview in Phase 2.

### **Confidentiality**

Confidentiality implies that the private data identifying the participants will not be disclosed. Where information may be recognisable to others, the participants should agree to the release of this identifiable information (Kvale and Brinkman, 2009).

For the purposes of maintaining confidentiality the position of three types of interview participants was considered.

For the Big 4 firm permission was obtained to conduct the research in general and to disclose findings as long as nothing could be attributed to individual clients and partners. This included contributing to discussion with Financial Reporting Council concerning findings.

For interviewees who had been part of the Big 4 firm's post decision review programme no individual comments have been identified; rather, as noted above the types of comments were identified.

For interviewees forming part of Phase 2 commitments were made to ensure that comments included within the study were non attributable. Assurances that comments made would be non-attributable were provided to the research participants. During the research a request was obtained from the Competition Commission to provide post decision review data for a five year period to February 2012. This included a number of interviews which formed part of this study. The request so far as it related to the interviews covered by the research was initially declined given the commitments which had been given to research participants that their information would be non attributable. In theory it may have been possible to mask or redact content of interview notes to maintain anonymity however there remained a substantial risk that interviewees could be identified by the circumstances of the proposal. Legal advice was obtained from the firm's competition lawyers who advised the substantial rights and responsibilities of the Competition Commission which meant that they were bound to maintain confidentiality and not to make public any information relating to individuals without their prior consent. Should information requested be withheld substantial financial penalties could have

been imposed. After consultation with Cranfield University involving the supervisor of this study, the university's ethics committee and the Vice Chancellor and following an express instruction from the Big 4 firm, the interview notes were released. Subsequent Competition Commission reports make no specific reference to the data requested.

### **Consequences**

The consequences of a qualitative study need to be considered to ensure that any potential harm to the participant should be the least possible and that the overall benefits accruing from the research outweigh any potential harm (Kvale and Brinkman, 2009). This means that the balance between benefits and risks should be considered.

The practical benefits of the study to understanding of the auditor selection decision in an environment where there were likely to be more audit tenders for companies, auditors and regulators was discussed above. The potential contribution to theory in the area of professional services supplier selection in an area where there is a paucity of research have also been discussed previously.

The risks to participants including interviewees and the Big 4 firm were assessed. The risks to interviewees given commitments made to non-attributable comments were assessed as minimal. There was potential for the Big 4 firm to be commercially disadvantaged by disclosing information which could be generally helpful to firms supplying audit services as it would help to explain buyer influences on this important decision. This was specifically

discussed with the leadership of the Big 4 firm who considered to the benefits to industry and the regulators of providing greater transparency around auditor selection outweighed any potential commercial disadvantages.

### **The role of the researcher**

The role of the researcher and in particular their integrity is critical to the quality of the knowledge obtained. In interviewing, the integrity of the researcher is especially important as the researcher him/herself is the instrument for obtaining scientific knowledge (Kvale and Brinkman, 2009).

In this study the potential influences on the independence of the researcher were identified at the outset. The research study is sponsored by a Big 4 firm and the researcher is employed by that firm. In relation to the influence of the Big 4 firm, no constraints or restrictions were provided; indeed that firm has encouraged transparency internally and externally to demystify the auditor selection decision. The researcher's own integrity was maintained by complete transparency of purpose and by honouring commitments made to interviewees. Even in response to intervention from the Competition Commission with substantial statutory powers information was not released until the public position of research participants was assured and detailed advice had been obtained from Cranfield University and the Big 4 firm's senior partners and the firm's legal advisers.

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**CHAPTER FOUR**  
**RESEARCH FINDINGS: PHASE 1**  
**REVIEW OF INTERVIEW RECORDS AUGUST 2002 TO MAY 2010**

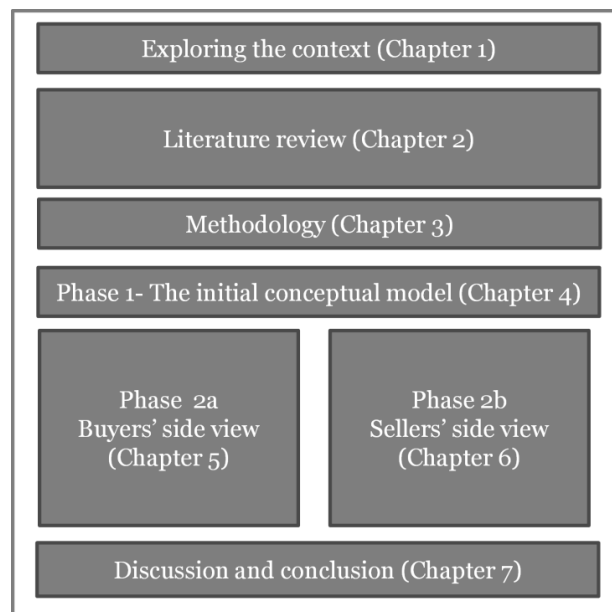
**4.0. Introduction**

The research findings chapters are organised so as to report the findings from the analysis of data relevant to answering the research question:

*“What are the factors affecting the auditor selection decisions of FTSE 350 companies in competitive tenders?”*

In line with the phased approach explained in the methodology chapter under Section 3.2 and following the contextual explanation (Chapter 1) and literature review (Chapter 2), these findings are organised into three further chapters; each covering one phase of the research as set out in Figure 8.

Chapter 4 explores the findings from the analysis of interview records provided by a Big 4 firm for the period August 2002 to May 2010. Following this introduction this chapter is split into six sections.



The first section explains the five factor groups influencing auditor selection that were identified from the analysis. These were consistent with and developed upon the themes which were highlighted from the literature review. As well as considering these five factor groups independently, the analysis also extends the themes identified from the literature review by identifying the factors underlying these themes in the auditor selection context and also starts to consider the linkages between them that the analysis identified (this latter point is then developed following the analysis of the two parts of Phase 2).

Five further sections then discuss in turn these factor groups influencing auditor selection namely; Relationships and track record (at the start of the proposal process), Service design, Capabilities and competences (of the proposing firms and teams), Behavioural influences (during the process) and Final decision making. Chapter 4 then concludes with the outline of an initial conceptual model.

Following this chapter there are two further chapters that examine the results from Phases 2a and 2b respectively. Chapter 5 discusses the findings from Phase 2a, consisting of 23 in depth semi- structured interviews conducted with company executives and non-executive directors with recent experience of involvement in 17 different auditor selection decisions which took place in the period between May 2010 and September 2012. This chapter is structured in a manner consistent with Chapter 4 and, as will be explained, the analysis of these data supported the influence of the same five factor groups; although as will be shown the analysis did reveal some differences both in the nature and in the

weight of certain underlying influences. Chapter 5 includes the discussion of revised conceptual model.

Chapter 6 then sets out the findings from Phase 2b which involved a further 24 in depth semi-structured interviews conducted with partners of a Big 4 firm and covering 12 of the 17 decisions analysed in Phase 2a; those being the decisions where that firm tendered. The analysis of this final set of data produced consistent results with the other two phases in that the same five factor groups influencing auditor selection were present, but there were again differences between the nature and frequencies of mention of each individual higher order category as compared to the first two phases.

Discussion of the findings and the contribution of the thesis to theory and practice are then included within Chapter 7.

Throughout the three phases the term “reference” will be used to mean the presence of a topic in the data and its extraction into an Nvivo code. This is consistent with the terminology used in the Nvivo software. The term “interview records” will be used to describe the post tender interview data provided by the Big 4 firm and used in Phase 1.

#### 4.1. Review of Big 4 firm's post tender interview records:

##### August 2002 to May 2010

The first set of results relate to Phase 1 of the research namely the analysis of the post decision interview records provided by a Big 4 firm for the period August 2002 to May 2010 and the creation of an initial conceptual model. The analysis was conducted in accordance with the approach set out in Section 3.2.4 above.

In total 66 contemporaneous post decision review interview records (or “sources”) were analysed. Across the interview records the analysis identified 515 nodes and 2251 references (as defined above) in relation to the tender decisions analysed, were assigned to these nodes (on

average some 34 references per interview record). The axial coding process described in Chapter 3 assigned these nodes into factors which in turn fell within five factor groups influencing the auditor selection decision. The presence of these five factor groups was very clear with each being present in over 90% of the interview records. As noted in Section 4.0 the five factor groups influencing the auditor selection decision identified were: Relationships and track record (at the start of the proposal process), Service design, Capabilities

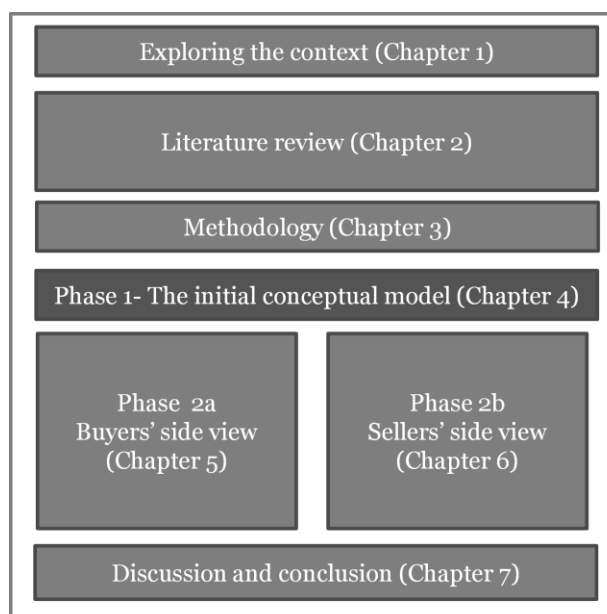


Figure 9: Phase 1 within the overall research approach



and competences (of the competing firms and teams), Behavioural influences (during the proposal process) and Final decision making.

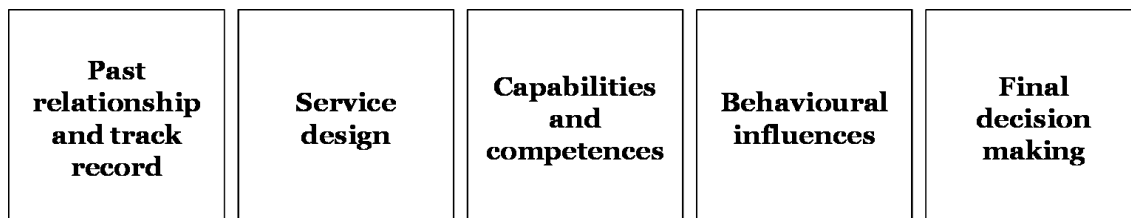


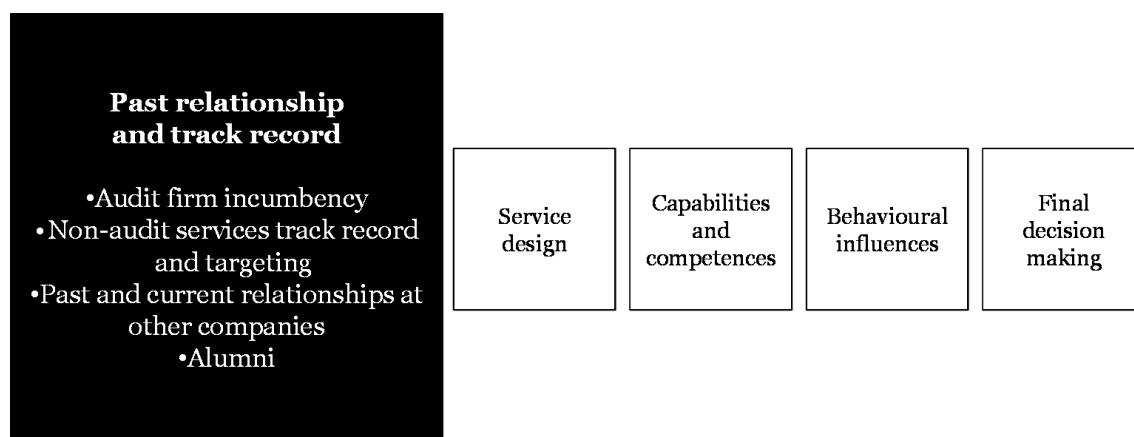
Figure 10: Five factor groups of influences on auditor selection

In the next five sections the factor groups are each considered in turn. As noted above, all five factor groups were very prevalent and no particular inference should be drawn at this stage from the order in which they are presented. Within each factor group, individual factors are presented in descending order determined by the number of interview records (or sources) which were found to refer to them.

Throughout reference will be made to the number of interviews where particular issues were highlighted in the interview notes and, in places, also the number of references made to them in those notes. This has been done to provide some indication of the regularity of occurrence although it is acknowledged that because this stage of the research is based on interview records rather than transcripts, these results can only be indicative. Each of these notes provided insights concerning the auditor selection decision for the company concerned, however the interview records contained varying degrees of detail so they provide only an approximation of the number of times each matter was mentioned. A more accurate assessment of occurrence is provided by Phase 2.

In addition selected extracts from the interview notes will be used to help to illustrate how factor groups and individual factors were manifest in the interview records.

#### **4.2. Relationships and past track record at the start of the tender process**



The analysis of the findings of Phase 1 of the research identified the relationship context and events leading up to the audit proposal as important influences on the auditor selection decision. This was present in each of the interview records and 509 references were recorded.

This first phase of the research identified four main factors of data in the interview records concerning the relationships which companies had with their incumbent auditors and other firms leading up to a tender process. These are set out in Table 13 along with the numbers of sources and references identified for each.

<b>Factors</b>	<b>Sources</b>	<b>References</b>
<b>Audit firm incumbency</b>	<b>62</b>	<b>361</b>
• Track record	53	155
• Inherent position for incumbent auditors	42	147
• Auditor transition	34	59
<b>Non-audit services track record and targeting</b>	<b>31</b>	<b>73</b>
<b>Past and current relationships at other companies</b>	<b>20</b>	<b>35</b>
<b>Alumni</b>	<b>13</b>	<b>20</b>
<b>Other relationship matters</b>	<b>14</b>	<b>19</b>

Table 13: Phase 1 relationships and track record sources and references by factor (NB the sum of the sources within the audit incumbency subheading exceeds the disclosed total number of sources due to consolidation in the Nvivo analysis i.e. where a source interview record included references to more than one subcategory. This consolidation does not affect the number of references).

The four main individual factors influencing auditor selection namely audit firm incumbency, non-audit services track record and targeting, past and current relationships at other companies and alumni are now considered in more detail. Further comments are also made about the other relationship matters identified.

The consideration of findings starts with the company's relationship with its incumbent auditor which was by far the most prevalent topic identified.

#### **4.2.1. Audit firm incumbency**

The relationship between the tendering company and its incumbent auditor was discussed in 62 (94%) of the interview records analysed and 361 references were recorded from those records; making it perhaps unsurprisingly a very substantial part of the discussion about past relationships.

Furthermore the analysis identified the relationship of the company with its incumbent auditor (and therefore the potential for that auditor to be re-appointed) being influenced both by the specific service track record of delivery provided by the incumbent auditor but also by inherent situational

circumstances. These latter influences included those forces which were inherently encouraging change, those inherently favouring the incumbent and considerations pertaining to the pros and cons of auditor transition. Each of these influences on auditor selection pertaining to the incumbent is now considered in turn.

### **Past service track record**

Consistent with the high switching rates identified in Section 1.4.2 and the discussion of switching covered in Chapter 2, the interview records identified a much higher proportion of companies with service problems in the period leading up to the tenders. In total past service problems were explicitly identified in 46 (70%) of the source interview records. Most commonly problems had contributed to putting the audit out to tender and although there was not in most cases a definitive position to change they did leave the incumbent auditor in a weaker position. The following interview record reference typifies the tone:

*Chair of audit committee: [Audit firm] had had a lot of ground to make up and some might have been inclined to forgive them the past but this was probably not realistic.*

In contrast only 20 (30%) of the interviews identified a positive incumbent track record (NB in a small number of cases the records identified both problems and positives). This normally occurred where audit proposals were driven by auditor consolidation or by a perceived corporate governance need for a tender.

In many of the interview records comments made about incumbent auditors related to general levels of dissatisfaction. The interview records did however also highlight a number of specific problems that had been experienced with incumbent auditors and these are considered in the following sections.

### **Dealing with technical accounting issues**

Amongst the specific problems identified, the failure of an audit firm to deal with accounting issues was the most prevalent (identified in 19 interview records) and especially when new standards were applied notably at the time of the implementation of new International Financial Reporting Standards (although not restricted to that).

These instances included situations when companies became concerned that their lead audit partners were not empowered to approve accounting treatments adopted by the companies. (NB each of the major audit firms has a central department which assists audit partners on complex accounting matters. This group typically includes partners who work with standard setters to understand and interpret new accounting developments. They also typically coordinate meetings where a panel of audit partners may meet together to discuss a specific client accounting issue which is particularly complex or sensitive). A number of companies felt that their audit partners were being disempowered and the real decisions were being made behind the scenes.

This is exemplified by an extract from an interview note containing a comment from one company finance director:

*.. it seemed that the audit team had moved away from being able to answer [him] on technical issues . It seemed like a new laborious process had been introduced whereby cases were put on the table and then referred somewhere in the labyrinth of [audit firm] and then some days later while smoke or black smoke would appear..... the relationship had changed such that nothing could be done without referring back to head office... in spite of assurances given by [senior partner] [company finance director] doesn't feel like the local team is empowered.*

Companies also expressed frustration when accounting issues were resolved too slowly or had concerns about the way these issues were being resolved. For example, where an incumbent audit firm was considered intransigent or was unwilling to enter into a debate.

There was also concern where an audit firm had appeared to change its position on an accounting issue (from initially accepting the position put forward by a company to disagreeing with it) or where the same audit firm had signed an audit opinion at another company where the same issue had been dealt with in a different way.

### **Other service problems identified**

Although failure to resolve accounting issues satisfactorily was the most frequently identified service problem in this first phase of research, other service problems were also identified albeit less often in the interview records. These included coordination and control of overseas offices (where concerns were identified about the lead office being able to control or coordinate its own

overseas network effectively (six instances), problems with non-audit services being delivered (six instances) which tainted the audit relationship (for example where there was a perceived failing in a non-audit assignment) and fee disputes (five instances).

In addition to potential damage to the incumbent auditor's chance of being reappointed following a tender process these service problems also appear to have had an influence on future service design and audit proposal evaluation criteria. Having gone through a poor experience in a particular area (for example accounting issue resolution) companies were sensitive to the issue and its importance increased when selecting a new auditor). This is returned to in Section 4.3 when service design is discussed.

But as noted above the likelihood of an incumbent auditor to be reappointed seems not only to be affected by their service track record with the company. In addition to past service problems, the interview records also identified influences on the auditor selection decision driven by more general attributes associated with incumbency and these are considered next.

### **Inherent position for incumbent auditors**

Inherent disadvantages for the incumbent were identified in 34 (52%) of the interview records. The themes which emerged are set out next.

#### **Forces for change**

The influences identified relating to the inherent position of an incumbent auditor were more often than not unfavourable. Forces for change were

identified in 18 interview records. These included new management looking for new things (five instances). Incumbent firms were therefore at risk where there were new executives who wanted to change things as the following reference from an interview record exemplifies:

*[Group Financial Controller] explained that [CEO] and [CFO] had been generally looking across all their suppliers including professional services – “every adviser” and it was therefore natural that [incumbent auditor] were going to be reviewed. Having said that however [CFO] had come in new and considered how things were done and it was not what he expected.*

The more general degree of change within the company was also seen on occasion to have created an environment where those involved were positive or at least more accepting of change (four instances).

There were also examples of “guilt by association” (four instances) where companies had had their own accounting or internal control problems which were not considered to be the fault of the auditor but which still caused them to question the quality of that auditor’s work. Although the company was responsible for its own management and accounting it still questioned “where were the auditors?” when things went wrong.

### **Why now?**

In addition to these forces for change, incumbent auditors could also place themselves at risk by changing their service propositions in response to the proposal. Auditors were seen to be at a disadvantage through the very act of



trying to improve their service offering (nine instances). In these instances where incumbents had brought new ideas and innovation companies questioned why they had not done so before. Companies felt let down that an audit tender had been necessary to stimulate the offer of improved service from their incumbent auditor.

Weighing against the inherent disadvantages was the value that companies saw in the knowledge that incumbent auditors had of companies and this is considered next.

### **Incumbent knowledge**

Companies acknowledged the value of an established understanding of their business that incumbent auditors possessed (17 instances). Interestingly however the records often mentioned this when conducting a comparison of inherent advantages and disadvantages that an incumbent might have. There was a sense that this knowledge was recognised but in the context of other (stronger?) influences which were disadvantageous to the incumbent.

In addition, in eight cases incumbent knowledge was identified only as a shortlisting factor where companies were consolidating auditors following a company merger (i.e. only incumbents were on the tender list but since they all had knowledge of some part of the group this did not necessarily provide an advantage to any one firm in the final decision making).

### **Audit transition**

The long tenure periods of FTSE 350 auditors and low overall switching rates were discussed in Chapter 1. One of the reasons highlighted for low switching rates was the cost of changing to a new auditor. New auditors would initially lack the cumulative knowledge and experience of an established incumbent. Although it is normal market practice for an incoming auditor to invest time in building their knowledge without charging the company for the costs incurred there is nonetheless and inevitably a degree of disruption for companies as they bring the new auditor up to speed. This process is normally referred to as audit transition.

Audit transition was identified as a factor that *could* advantage the incumbent although the analysis identified quite a mixed picture as to its influence on the selection decision. There were in total 34 (52%) of the interview records which included references to audit transition. There were however only a slightly higher number (16 instances) where the focus was on the potential risk and disruption of transition as compared to those which identified change as a positive (13 instances).

Where transition was mentioned, concerns were identified about both the perceived risks of transition and the level of disruption. For example:

*[CFO] The discussion following the presentation had a large element around the risks of change. There were three people in the discussion who were ex-profession and so understood. There was a debate around the process of change and which parts might be easy and which might be more difficult.*

From the records it wasn't possible to identify the specific risks that companies were concerned about. The notes talk mainly about transition risk generally. Concerns over disruption however were normally associated with worries about the time investment that companies would have to make to effect the transition (NB: Oxera (2006) also identified inter alia transition concerns to include the time investment of management and the audit committee).

Those influences encouraging an auditor change might be encapsulated by the term "time for a change" (13 instances). Within this group there was reference to the benefits of a "fresh look" (four instances) and the general view that change was a positive (three instances). One finance director commented:

*..there was something about a fresh pair of eyes and new ideas which made change attractive"*

It was also however noticeable that interview records identifying a positive attitude to change were often those which contained references to past service problems. So in many of these cases a readiness to change included a combination of past experience and attitude to change.

The potential risks and disruption could also be mitigated by transition planning (10 instances). The non-incumbent "challenger" firms sought to demonstrate that the risk and disruption of transition could be managed and mitigated. To support this detailed plans were submitted by the non-incumbent audit firms to demonstrate how they would work with the company to achieve this (five instances). This could also extend to the preparation and submission of plans for the audit itself (four instances). References were also made in the

interview records to the thoroughness of transition planning including the completion of audit plans as the next reference illustrates:

*[Chair of Audit Committee]: [Audit firm] gave the impression that they had done a lot of work already in terms of preparation for the audit. It seemed that they had done much of their audit planning.... This reinforced the impression that [audit firm] had done a lot of work to get the job. Their document was very detailed and gave the impression that they would be very hands on.*

Overall concerns over the potential risk and disruption caused by change seemed to have a varying although mostly relatively low influence on the auditor selection decision. There were some instances of transition concerns supporting the reappointment of the incumbent but for others these concerns were outweighed by other factors. The interview records also highlighted companies for whom transition risk was not considered to be significant at all.

The analysis seems to indicate that once a tender is instigated, companies either want to change, or are open to change auditor and in this situation transition concerns are either discounted or planned for in their selection deliberations; the latter situation supported by transition plans submitted by the “challenger” firms.

The incumbent auditor therefore appeared under threat in most audit proposals for service or other reasons associated more generally with incumbency; their service track record affecting both their reappointment chances and shaping service design. This contrasts with some previous

literature indicating that incumbent suppliers tend to have an advantage over new suppliers.

#### **4.2.2. Other (non-incumbent) audit firms' relationships with the tendering company and targeting**

In the previous section the position of the incumbent auditor prior to an audit tender was discussed. The increasing restrictions on auditors performing other services for their audit clients were however discussed in Chapter 1. This has meant organisations having broader professional service relationships with the Big 4 and the likelihood of relationships and track records being developed which could influence the auditor selection.

The analysis identified 31 (47%) of the interview records which referred to the influence of past non-audit service and targeting track records with the company and on the selection decision. This included instances where firms had non-audit service relationships and where they were targeting the company (as defined below).

##### **Past non-audit service relationships**

The discussion of past non-audit service relationships (22 instances) included tax services (10 instances), transaction support (two instances), accounting advice and regulatory services.

In the previous section the influence of a track record for an incumbent was identified. The interview records suggest that a similar influence can be established by other non-incumbent firms through their track record of

delivering other services; the way that a firm approached non-audit services being taken as indicative of the way that they might approach the audit.

For the most frequently talked about service included here, taxation, of the 10 instances identified seven were positive for the firm involved and only two negative. In the remaining case the company had tax relationships with all the firms.

Indeed the track record on other services could be decisive as the following reference suggests:

*[CFO] So to the key question why did they go with [Firm x] rather than [Firm y]? It became clear that they felt they had a proven working relationship with [Firm x]. This relationship had arisen from transaction history and from [Firm x]*

Conversely where there were problems with the non-audit services relationship there could be a similar negative influence on auditor selection (two instances).

### **Targeting**

In addition to providing non-audit services the interviews also identified the influence of the closely related activity of company “targeting”. Targeting in this context means a range of activities undertaken by a firm aimed at developing relationships and selling services to identified target companies. Over a quarter (18 instances) of the interview records included reference to activities and investments in marketing and relationship building undertaken by

the firms in an attempt to win work. These included a range of activities from general contact to more formal programmes for non-executives. A number of interview records suggested this to be a positive influence both because of the value it had delivered and the message it communicated about the firms' interest in working with the companies involved. For example:

*[Firm x] had been targeting [Company] and had sent literature and had one or two meetings with the CFO..... They had also stayed in touch on tax. [ACC] had also been to at least one of their non-executive briefings in London. They were "dead keen"*

In 11 cases companies talked generally about the targeting efforts the firms had made and in nine of these cases they were identified either as a positive for a firm where this had taken place or a negative where it had not.

#### **4.2.3. Current and past relationships at other companies**

In the past two sections the influence of audit firms' past service track records with tendering companies on auditor selection was considered. Section 1.4.1 however also highlighted the presence of cross directorships and movements of directors between FTSE 350 companies. This means that many directors also have current or past personal experience of being served by audit firms and their partners and staff in *other* companies. This section therefore considers the Phase 1 interview record references as they related to past working relationships of those selecting auditors and the experience of working with auditors at current cross directorships.

### **Past service relationships at other companies.**

The interview records showed auditor selection committee members having had past audit and other service relationships at other companies (11 instances) and normally (although not exclusively) these experiences had been positive.

The interview records were not always detailed or explicit about the operation of these relationships but where the detail was explained it showed that past service relationships at other companies could be very influential. For example positive aspects of delivery such as proven robustness and the ability to work together effectively were specifically highlighted in three cases and in two of those cases the proposing partner from the relevant firm had been the director's audit partner previously. The following reference illustrates the point:

*[CEO] The [successful non-incumbent] team was known to the key players on the Board and known to be robust and strong through the association [as auditors] at [his previous employment]*

Consistent with the previous subsection, pre-tender behaviour being taken as likely behaviour should the relevant firm be appointed.

### **Current cross directorships**

Given the extent of cross directorships identified in Section 1.4.1 the number of interview records which referred to directors' current cross directorships was perhaps relatively small (mentioned in only 8 interview



records). Where mentioned cross directorships were seen to complicate matters and these connections were not always positive for the audit firm involved.

For example in one case a firm was excluded from the audit tender shortlist because a director had had a poor experience with that firm at another company where he was a director. In another case there were concurrent audit tenders being conducted by companies which had a common director. In this case it was suggested that it might be unlikely for the same firm to be appointed auditor to both companies as the director concerned would not want to concentrate their relationships with one firm.

Another complication arose where in a tender for one company, a firm was offering something which a director hadn't seen at another company where he was a director and that firm was the auditor. He was unimpressed that the tender had identified that the firm was offering a valuable service which he had not seen before.

The interview records therefore identified the influence of service track records both positive and negative from outside the tendering company albeit that there were fewer mentions of this than the other relationship influences outlined above.

Another source of potential influence on auditor selection came not from a service track record, but from past employment with one of the Big 4 firms. The influence of alumni relationships is therefore considered next.

#### **4.2.4. Alumni**

The high level of presence of Big 4 alumni as directors of FTSE 350 companies was noted in Section 1.4.1. An influence of alumni on auditor selection was confirmed by the current research, indeed alumni were referenced 13 (20%) times in the source interview records. Interestingly however the influence of such alumni was not always positive for their “old firm”.

There were examples in approximately equal numbers of alumni being involved in appointing their “old firm” and in appointing another firm. Although a degree of loyalty might have been expected the notes also showed antipathy.

Other references acknowledged the sensitive position alumni and their former firms are in; the alumni not wishing to appear biased and their firms not seeking to put them in a difficult position. As the following reference illustrates:

*[Audit Committee Member] feels that alumni are “a double edged sword”. He thought dangers [sic]. Firstly alumni can be sensitive to their position and not wish to be seen to be too supportive of their old firm; they “aim off”. Secondly firms might “get more relaxed”. He questioned on [Company] whether the presence of two senior alumni of [Firm x] may have caused [Firm x] to put less effort into the proposal perhaps assuming some sense of an established relationship.*

The presence of alumni from the competing firms therefore appeared to influence auditor selection but the nature and extent of that influence could be different depending on the individual circumstances.

#### **4.2.5. Other relationship matters**

##### **Other matters**

Aside from the matters discussed in the subsections above, the interview data were perhaps also interesting because of the topics that they *didn't* highlight or highlighted very thinly. For example, there was no data reference to friends influencing decisions. In the high profile environment explained in Chapter 1, the evidence from the interview records suggests and that relationship influences on the selection decision were being derived from past professional working relationships and not from other more social or personal relationships. Indeed as the example of alumni suggests, companies appeared sensitive not to let this introduce bias.

Given the literature discussed in Chapter 2 and in the context of the rights of the auditor and generally long periods of auditor tenure discussed in Chapter 1, it might have been expected that the research would highlight high levels of discussion about the influence of loyalty and/or trust. There were references to trust which included people looking for people they could trust and commenting adversely where they felt they could not trust people. However the amount of discussion was low and trust was mentioned in only eight (12%) of the interviews.

Furthermore there was very little reference to affective influences; other than a small number of instances which highlighted how companies became frustrated with what they saw as arrogance in failing to deal with accounting issues (this lack of apparent emotion in looking back may be contrasted with the

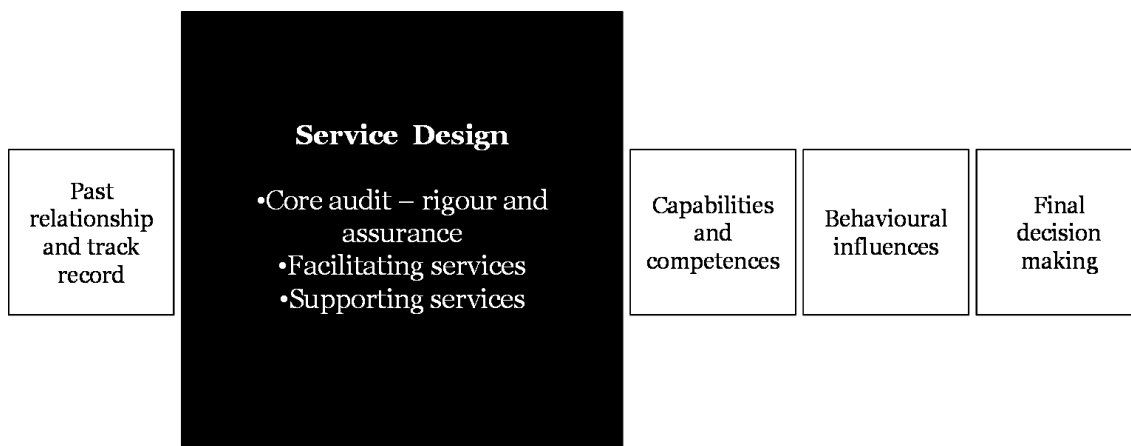
affective influences identified from behaviour during the process and considered below in Section 4.5).

Again perhaps surprisingly, given the importance of word of mouth that had been highlighted by the literature in Chapter 2, the level of explicit comment on companies taking references on individuals or firms was low. In only six instances did the interview records identify companies taking references or talking to others outside the organisation more generally to obtain views on the competing firms or teams. In only one was an extensive exercise identified in relation to references. Consistent with the generally extensive processes highlighted in Chapter 1, companies appeared to be relying more on their own assessments and experiences.

There was even less explicit reference to loyalty in this phase of the research (five instances). Indeed in two of these cases comments related to how *unimportant* it was to the selection process.

This section concludes the findings from the Big 4 interview records as they related to relationships and past track record at the start of proposal processes. They suggest a relationship influence on service design and expected behaviour. The next section now examines the next factor group namely audit service design.

### 4.3. Service design



The second factor group influencing auditor selection is audit service design. The Phase 1 analysis of the interview records highlighted important elements of the audit service design, including planned execution and proposed outputs as influences on auditor selection. In total 61 (92%) of the interview records referred to it and there were 303 references.

In Chapter 1 reference was made to Oxera (2006) identifying that an audit had three elements: insurance, core and value add. Oxera's previous work was not fully supported by the current research. Phase 1 identified no explicit references to the audit as insurance. That said, as set out below, companies were looking for audit rigour (and the dominance of the Big 4 may have meant that any insurance element of the selection may have been considered present in each Big 4 firm and therefore assumed in the context of a selection decision between them).

The analysis of Phase 1 also shows a difficulty in separating what is core from what is value added. For example an auditor is required under auditing

standards to review accounting controls, but the way the audit is organised to test those controls and feedback is identified as a source of value as will be further explored below. Similarly coordination and communication are essential for audit delivery but their manner and focus, and the quality of communication has also been identified as valuable feedback.

After considering the material in the interview records which talks about whether audit can generally be differentiated by buyers of audit services, the analysis of specific differentiators is set out using a classification developed by Gronroos (2007). The Gronroos core and augmented services framework appeared to provide a better fit with the findings than that suggested by Oxera and is explained on page 169.

#### **4.3.1. Audit approach - general differentiation and tailoring**

Discussion of attributes of the audit service was included in 65 (98%) of the 66 source interview records analysed as part of Phase 1. Within this group, companies talked about the positive influence of the audit approaches being proposed by the firms when they were specific, flexible and meeting their specific needs and plans, and negatively when this was not the case (16 instances) . References were also made to general differences in audit approaches (eight instances); either where companies were comparing the proposed audit approaches with what they had received before, or making comparisons between the audit approaches being proposed by the tendering firms.

So, although not explicit in every interview record there was evidence of audits being tailored and companies identifying different approaches; thus differentiation being an influence on auditor selection.

In addition to references to general differences being identified there were also more specific references to areas of focus in auditor selection including audit delivery, ideas and innovation, fees and transition. These are considered in the next sections. As noted above, a core and augmented service classification based on a model originated by Gronroos (2007) was considered a good fit with the findings of this phase of the research.

According to Gronroos (2007) the core service is defined by the type of business in which the firm is competing. The augmented service includes the core service and in addition the supplementary services that surround it. These supplementary services may then in turn be divided between facilitation services, which are indispensable to the delivery of the core service, and supporting services, which add value to the core product.

Although this classification is not without challenges in the context of auditor selection (not least because the definition of the core audit is not wholly understood by its users despite being prescribed by statute and regulation) the expectations gap (referred to in Section 1.2) it does provide a framework for ordering the discussion of the identified factors influencing auditor selection identified in the interview records.

The following sections are therefore ordered firstly to consider audit rigour and assurance, which may be considered as broadly analogous to core audit,

secondly, the four most commonly identified facilitating services of the on-going audit are considered; namely coordination and communication, accounting technical matters, IT and systems audit, and working with internal audit. Thirdly, the main supporting service; that of ideas and insight from the audit is considered before reviewing references made to commercial arrangements.

#### **4.3.2. Core audit – audit rigour and assurance**

For the purposes of this analysis the core audit has been taken to include comments made about the underlying audit and the assurance that companies seek from it. Assurance in turn relates to giving comfort to the company that a thorough and rigorous audit has been completed such that the risk of errors in the accounts has been minimised. This is consistent with the definition of audit quality from Deangelo (1981) as it relates to consideration of whether auditors were likely to identify and then report errors. The requirement here is commonly referred to within the profession as “no surprises”.

The analysis of interview records identified that companies were indeed looking for audit rigour and assurance, this having been discussed in 21 (48%) of the interviews. There was evidence of both executives and non-executives looking for rigour and assurance from the audit. One way that this was expressed was in the value companies ascribed to being challenged by their auditors (seven instances). For others robustness was important (three instances) and in another case the underlying rigour and assurance being sought would be manifest in a degree of intrusiveness.



For these 21 people (at least) their auditor selection assessments were then influenced by audit rigour. The nature of this influence is exemplified by comments noted to have been made an Audit Committee Chair namely:

*[Audit Committee Chair]: Technical [audit] approach was forest for trees but it doesn't mean it's not important – I wanted to be able to sleep at night.*

In Section 4.2.1 it was identified that performance in non-audit services prior to an audit tender could be taken as indicative of what might follow. This extended to positive influence of rigour as the following illustrates:

*[CFO] knew that [successful firm] would push [the company] hard, [successful firm] had always delivered [in non-audit services] and [the company] wanted robustness from their auditors.*

There was therefore interview record evidence of companies looking for rigour and assurance from their audit. There were also references to the facilitating services surrounding the audit and these are considered next.

#### **4.3.3. Facilitating services**

For the purposes of this analysis, facilitating services fundamental to the delivery of the core audit have been defined to include the four most often discussed elements of: coordination and communication relating to the audit, accounting technical support, approach to IT systems and controls and working with internal audit. Other factors were discussed less often as Table 14 shows.

The four main facilitating services influences on auditor selection are set out in Table 14 below along with the number of sources and references identified from the interview records for each subcategory. These are then considered in the sections that follow.

Factors	Sources	References
Coordination and communication	21	42
Accounting technical support	16	27
Working with internal audit	13	19
IT systems and controls	13	13
Other	7	8

Table 14: Phase 1 sources and references for Facilitating services

### **Coordination and communication**

Many FTSE 350 audits have substantial international operations with audit work often undertaken in many different territories. Coordination and the management of communication of that work can be quite a large exercise: 21 (32%) of the interviews referred to it.

The importance of coordination specifically was discussed in 13 of the interview records. Concerns were identified about coordination of international audit work generally and in relation to coordination in key operational territories for the company. The area of international coordination was previously identified as a problem for auditors in Section 4.2.1.

There is also evidence of companies comparing the audit firms in tender processes as to their likely ability to coordinate internationally and the important influence that this could have on a selection decision. For example:

*[Finance Director] We talked about the reasons behind [audit firm] winning on the day. Both felt that [audit firm] had got it right in focussing on the global coordination point – this was a big issue for the Audit Committee and the NEDs.*

Communication in an audit context was discussed in ten interview records and can be multidimensional. Typically there will be communication between auditor and company at a local level and between the local operations and head office of the company and between local auditors and the group auditor. In addition there is communication at the company between management and the audit committee and also auditor communication with both. Both formal and informal reporting were important as part of auditors feeding back on the results of their work. This feedback is sometimes referred to as the auditor acting as the “eyes and ears” for management and the audit committee and feedback could include qualitative observations on issues.

The importance of reporting to the audit committee is illustrated by one non-executive director:

*....communication and reporting are critical. Audit committees need to know not just is it alright but how alright is it? Not just OK or not [but] year on year have we got closer to the edge... how are [our accounting] treatments were evolving over time.*

The style of communication was also important with companies looking for a balance between auditors standing firm on key issues but not being unnecessarily inflexible where it didn't matter. For example:

*[Senior Executive]: [Lead Partner] was “always sensible” “allows stuff that doesn’t matter to go through” but “stands her ground”*

Consideration of the influence of communication style is returned to in Section 4.4.3 where the influence on auditor selection of the capabilities and competitiveness of the lead partner are considered.

The importance of communication and reporting being accurate but balanced was also identified. Achieving accurate feedback from divisional audits was also seen as important.

The interview records therefore identified aspects of both communication and coordination of the audit which companies had considered during their auditor selection decisions. In total 21 interview records identified these matters.

### **Dealing with accounting technical matters**

In Section 4.2.1 above the problems for incumbent auditors with poor track records were discussed. One of the problem areas was accounting issue resolution. The interview data suggests that these past relationship issues were not only counting against the incumbent as noted above but were, perhaps unsurprisingly, also shaping the future service offering required. There were 16 interviews which discussed accounting technical matters.

Within the area of accounting technical matters, the resolution of accounting issues was most frequently identified (12 instances). Examples were identified of tendering audit firms providing commitments on responsibility and

accountability in relation to resolving accounting issues; (notably around empowerment of the lead partner as having final responsibility for important accounting decisions) and also about the time it would take to resolve accounting issues (in the form of turnaround times for accounting technical queries).

Evidence was also present of companies explicitly assessing audit firms in relation to how they proposed to deal with accounting issues. For example:

*[Audit Committee Chair] went on to talk about what he saw as [Firm x] biggest negative. In his words “the feeling was that when it came down to an accounting treatment issue or a controversy, [Firm x] would be more inclined put their own interests 1<sup>st</sup> and those of the client 2<sup>nd</sup> “. [Company] had deliberately posed a series of questions aimed at testing the degree to which the auditor would support a client’s position and had concluded that [Firm y] would be more client centric when making their decisions and judgements*

In addition to providing evidence of the influence of resolving accounting issues, the interview records also included comment on the value of informed accounting judgement and the need for auditors to advise companies on the overall prudence of their approaches.

Within accounting technical matters there were fewer records relating to the need for more general accounting updates and support (eight instances) but there was at least one reference to each of: helping the company to produce the highest quality annual report as possible, keeping company directors on top of emerging or complex accounting issues, providing a range of options for

accounting treatments, speed of response for routine enquires and dealing with accounting standard setters to achieve pragmatic solutions.

### **Working with internal audit**

Most FTSE 350 companies have an internal audit function and indeed it is a requirement of the UK Corporate Governance Code that audit committees are required to consider whether there is a need for such a function each year where there is no such internal audit function in place. Such functions are normally internally staffed and/or outsourced to an audit firm other than the external auditor.

Depending upon the type of work that internal audit performs, there is potential for overlap between internal audit and external audit. The principal issue identified in the ten interview records that included references to aspects of working with internal audit was the working relationship between internal audit and external audit and in particular the approach to collaborating and coordinating their audit plans and the extent to which external audit was relying on the work of internal audit.

Companies were looking for active engagement between internal audit and external audit including joint planning and permissible secondments (13 instances).

In one case however a high degree of integration had attracted regulatory interest because of the risk to independence of the external audit should the external auditors be conducting internal audit work. There is evidence that

selection decisions seem to be balancing the desire for collaborative approaches with internal audit, with the independence requirements needed for the statutory external audit.

### **IT systems and controls**

Auditing standards require auditors to assess the adequacy of companies' accounting systems and controls and, where they are tested and found to be operating properly, auditors are entitled under those standards to rely on them and to reduce the amount of substantive tests of individual transactions that they need to conduct during their audit.

The interview data suggests that different companies expected different levels of reliance to be placed on their systems and controls and that the firms' responses to these different expectations influenced their auditor selection decisions (13 instances). Those wanting greater reliance commented positively about reliance on systems and controls and criticised more substantive approaches based on checking individual balances and transactions.

For example: *[CFO ] [Audit firm] had become very substantive. The work seemed to be ingrained into large amounts of checking of low risk areas away from the key risk and control issues.*

Such companies saw the audit as supporting their systems and controls developments, for example assessing how well the audit approach was aligned to their plans for shared services and how well it kept in step with their plans for

the development of their internal control processes and procedures more broadly.

#### **4.3.4. Supporting services - ideas and insights from the audit**

The special rights and responsibilities of statutory auditors were explained in Chapter 1. As noted there, these rights and responsibilities give auditors unique access to companies as they conduct their audits. The interviews provide evidence (13 instances) that companies are expecting their auditors to use the experience that this access gives them to share ideas and provide insights as part of the audit; to help them with their businesses.

The insights that the companies were looking for included ideas and insights from their competitors, their industry and more generally. Although, as identified in Chapter 1, the auditor is subject to strict confidentiality rules, companies still expect them to share information not covered by those rules (on a non-attributable basis) and their ability to do so can therefore be an influence on the selection decision.

The information which companies expect auditors to share includes industry best practice, the best practices and procedures that their firms are delivering at other clients and from their other experiences. These ideas and innovations are expected to be delivered as part of the overall audit service. Closely related to this were a number of comments indicating the apparent influence on selection decisions of audits firms' behaviour in putting forward ideas and insights during a proposal process. So, for example whilst ideas and



insights may be valued, the very fact that they are being put forward may be influential as well as their quality. This is discussed further in Section 4.5 below.

#### **4.3.5. Commercial arrangements**

The previous sections have focussed on what the interview records identified companies were looking to get out of their audit service. This section now turns to findings related to the influence of audit fees on auditor selection decisions and the related area of the influence of the budgeted hours. Given the way that audits are normally costed, based on hourly rates and hours worked, the greater the number of hours, all other things being equal, the greater the fee. These commercial aspects were referred to in 46 (70%) of the interview records.

Typically in FTSE 350 tenders audit firms provide a fee quotation for one year, or more than one year, which is then fixed subject to any changes in the companies' organisation (for example acquisitions) or problems that could not have been foreseen at the time of the tender. These fixed fees may be quoted subject to an annual inflation adjustment.

Because audit fees are disclosed in the annual reports of UK listed companies, audit firms know the current level of fee paid before they enter into tenders, although as discussed in Chapter 1 above, reductions in fees following tenders have been typical in the past.

The most common theme identified in the interview data was of the relative *lack* of influence of fees on auditor selection decisions. This is an important finding that is consistent with certain auditor selection literature

(Beattie and Fearnley, 1995; Hermanson, 1994). Although this didn't apply in every case, there appear a number of different reasons why fees were not generally very influential to the final decision.

In some cases the interview records indicated that fees appeared to be of little influence because all of the firms proposed (or moved in negotiation to) fees that were very close in quantum with each other (in practice in most cases the quoted fees for the tenders covered in this phase would all be less than the fees paid before the tender). The following reference illustrates the point:

*[Audit Committee Chair] ...in this case fees from all three firms were very close, within a few thousand pounds. ....there was nothing in [it] and nothing worth haggling about with the eventual preferred supplier.*

There was also evidence that those selecting auditors considered fees not to be important per se stressing the relatively greater importance of getting the best job for a fair price. A few highlighted a concern that low fees might even undermine the relationship.

In this context it should be noted that there was an expectation that fees could be negotiated *after* a decision was made in principle based on other factors; and also that such negotiations did indeed take place. There was evidence therefore of fees, rather than being an influence on the selection decision, being a matter to be settled afterwards once the decision had been made. The following reference illustrates this point:

*[Group Finance Director] In relation to [audit firm] he thought that there were savings related [changes in the audit] that could be made and were not reflected in the quote. He asked [audit firm] to match the middle quote which [it] did. In [Group Finance Director]’s view the process was always going to be about selecting the firm that [company] wanted to work with and fees would always be negotiable with the selected firm.*

In one case a substantial downward revision in the proposed fee during the process had been influential as the Group Finance Director saw it as a strong signal of the audit firm’s desire to work with his organisation. However others were concerned about audit fees being too low; either where an incumbent firm proposed a fee substantially lower than their previous year’s fee or where the low fee caused the company to question the adequacy of the scope of work that was being proposed or the actions that the company would have to undertake to achieve the proposed fee.

Where high fees were identified as a problem, the interview data suggested that this could happen where these fees were presented in a way which suggested an inefficient approach, or where the company considered that more work than was necessary was being proposed (based on the past and bearing in mind that many of the interview records related to conversations with those who had been auditors in the past). The number of hours being proposed and the mix of hours were also therefore important; there were by and large buyers who were knowledgeable in this area as the negotiation of fees was a normal annual occurrence even without a tender. Knowledgeable buyers are not always the case in the purchase of professional services as highlighted in the literature

review in Chapter 2.

This section has considered interview record evidence as it related to commercial aspects of proposals. This suggests that the influence of audit fees on the auditor selection decision is generally low. This evidence also further suggests that where high fees have been seen to be problematic this seems generally to be associated with concerns over the scope of work performed. Low fees also seem to be problematic where incumbent firm's lower fees in proposals from their pre-tender levels (which seem to cause companies to question their approach to previous years) or where they give rise to concerns over the adequacy of the scope of work being proposed. That said, these results show that companies often expect price negotiations to be carried out post appointment.

This completes the Phase 1 consideration of audit service design influences on auditor selection. The analysis shows companies looking for rigour and assurance from the auditors. It also shows them looking for important facilitating aspects of service including coordination, appropriate communication and the right level of focus on companies' own accounting systems and controls, accounting issue resolution and working with internal audit. Furthermore ideas and insights that the proposing audit firms could provide were also recognised. The influence of fees appeared less important; either because quoted fees were similar or negotiations took place after the decision.

The next section considers the interview evidence as it relates to the influence of capabilities and competences of the firms and their teams on auditor selection.

#### 4.4. Capabilities and competences



In the previous section influences on the auditor selection decision identified from the interviews as they related to service design and assessment were discussed. The literature however suggests that service assessment for professional services with high credence qualities can be challenging because of the inherent difficulty of assessing them before (and during) the service. A theme from the review of the professional services and auditor selection literature was companies turning to assessments of firms' capabilities in their selection decisions (as well as behavioural cues which are discussed in Section 4.5). This third factor group therefore contains matters identified in the interview records which related to those capabilities and competences of the competing bidders.

The interview records provide substantial evidence that companies are considering capabilities and competences in their auditor selection decisions. References totalling 411 were identified and the topic was covered in all of the 66 records analysed. Furthermore the records show assessments being undertaken on a number of levels which may be categorised as: firms overall, the proposed team including assessment of key individuals within the team, and within the team especially the lead partner (which has therefore been split out from the rest of the team in the narrative that follows).

Table 15 shows the number of sources and references within the data identified for each of these levels. These are discussed in turn in the following subsections.

Factors	Sources	References
The proposed team	55	174
The audit firms	55	155
The lead partner	38	80

Table 15: Phase 1 Capabilities and competences sources and references by factor

#### **4.4.1. The team**

In this section the interview data as it relates to comments about teams is discussed. This includes references to individuals within the team, the structure of the team and the attributes of teams as a whole. As noted above and given the frequency of discussion of the lead partner this has been split out and is considered in Section 4.4.3.

### **Comparing individuals within the team**

The interview records provided a lot of evidence of companies assessing key individuals in the team. A total of 36 (55%) of the interviews referenced this (even after excluding the lead partner discussed below).

There were three groups of individuals who were subject to most discussion. Firstly the group or head office team under the lead partner, secondly the specialists involved as part of the audit and thirdly those overseas partners in key operational locations for the companies.

In relation to the group or head office team, 21 interviews discussed the group director or senior manager. Most of the comments made were general references to the strength or weakness of individuals in this role (17 instances). There was also acknowledgement of the importance of the individuals playing this role in the audit (six instances). For example:

*[CFO]: So it became about was the senior manager going to be any good? The more we thought about it the more important the senior manager was. [Audit senior manager] had not let them down.*

In a number of larger proposals (as considered further below) audit firms organise their teams with more than one partner overseeing the audit. Generally there is a more senior lead partner and a second partner. In 11 interviews the second partner was discussed, including their general strength (six instances) and their personal style (four instances).

Taken together, the team below the lead partner was seen as evidence of strength in depth as the following highlights:

*[Audit Committee Chair] went on to say that they had been very impressed with [Second partner and manager]. They were part of a great operational audit team. [Audit firm] strength in depth was a real differentiator.*

The second group of individuals referred to were specialists (16 instances). These included professionals who were risk management experts and systems and controls specialist auditors, industry experts and actuarial and accounting technical experts. The interview data suggests that these specialists can influence the auditor selection decision as long as their availability is assured and their role as part of the wider team is clear. An example extract from the interview records illustrates the point:

*It was also important that [Audit firm] had brought others into the picture. [Risk management expert] great – talked about risk”. “We want to know about the risk management structure. [CEO] knows [Risk management expert] – he has a “commercial pragmatic viewpoint in addition to knowing what the [Industry regulator] wants CFO thought – here’s the robustness we need.*

The third group of individuals referenced were partners in critical territories (11 instances). Discussion often turned to an overseas partner where the company conducting the tender had very large operations in particular countries, or where there had been problems; either with the audit or the



company's own accounting control environment in that location.

Most of the discussion in relation to overseas partners was restricted to consideration of whether they were considered to be strong or weak. It was not evident in many of the interviews why that might have been assessed to have been the case. Where there was additional information it related to understanding of the business associated with industry experience and expertise and personal style for example:

*[x partner] is the acceptable face of America.*

So, companies were assessing the individuals they met as part of the process. They were also keen to have clarity about how those individuals would work together and with them and this is considered next.

### **Audit team structure**

Most FTSE 350 companies are large organisations and as noted above many have considerable international operations. The audit is normally led by a group audit team and the different ways of structuring that team and the supporting teams was commented on in 24 (36%) of the interviews.

The most common theme within these interviews was about how the team was structured at the top. As noted above, given the size of FTSE 350 audits, there is often a need to have more than one partner working at the centre and leading and/or coordinating the global audit. Typically where this occurs there are two central partners; one more senior than the other. The interview records suggest that a number of different approaches have been adopted by the audit

firms which companies commented on in different ways in interviews about their auditor selection decisions.

There was evidence that some companies were looking for a two partner model with clarity of role between the two partners. For example

*[Executive management] were very keen to have a two partner relationship... [Successful audit firm] played two quite senior partners with the more senior as the signing partner.*

On the other hand where there was a lack of clarity companies commented negatively on it. As the following references illustrates:

*[Audit Committee Chair].[Auditor selection panel] were unsure how [senior partner] role was going to work as [company industry] expert. In some respects this was because [incumbent auditor] had proposed a London specialist as part of their team in their last proposal and the company hadn't seen him.*

A second theme identified in the interview records was the influence on decisions when audit firms involved more than one office in their proposed team. There is evidence that companies were concerned about how these offices will work together.

A third issue in relation to structure arose where a company had substantial UK operations or divisions in addition to its head office. In these cases different views were recorded in the interview data as to how best to

organise the audit team in response. The principle issue was whether the audit team leading the group should also audit the divisions.

Lastly, some of these large FTSE 350 companies are organised by global region (e.g. Americas, Europe, Middle East and Africa and Asia Pacific). In these cases there was interview evidence of the influence of audit firms responding appropriately to that structure by introducing a partner dedicated to coordination of their services to these global regions; allocating a dedicated partner to link with the company's regional management team.

In arriving at their auditor selection decision there is therefore evidence that companies are concerned about the structure and clarity of the team at the centre and cohesion between offices. There was also some interview evidence that companies were concerned that audit firms structured their teams to meet their own structure and there is also some variation in what they were looking for.

### **Attributes of the teams as a whole**

Lastly, under consideration of the influence of the teams, there was also evidence of companies including assessments of attributes of the team as a whole in their decisions. Consistent with the findings in relation to the firms discussed in the previous sections, industry experience and geographical factors were again present.

Industry experience (as with firms discussed above) was considered important and was identified in 16 (24%) of the interview records. This was in some cases connected with the team's history of working together. For example:

*[Chair of Audit Committee]: appreciated the industry experience in every member and they liked the fact that team members worked together well.*

There were ten interviews which discussed the influence of geography on companies' decision making. There were two principal issues. The first related to the location of the head office team where there was a company with a UK regional head office (five instances). There were differing views here between those who felt that a London led team would provide a greater level of rigour and challenge because they would have greater FTSE 350 experience as most of these companies have their head office in or around London. This compared with an alternative view that a local team would have greater understanding of the company's culture. In contrast with some of the literature, proximity was not discussed widely as a decision influence. Indeed it came up in only one interview.

The second issue identified (four instances) was having strong teams in key international locations. This is consistent with the comments made above about companies including international strength and depth in assessing firms and with those made above about companies assessing key overseas partners.

#### **4.4.2. The audit firms**

In Chapter 1 the dominance of the Big 4 firms was discussed. In relation to the analysis of the interview records two issues arose. Firstly, whether it was possible to differentiate *generally* between the Big 4 and secondly, the extent to which the Big 4 were generally differentiated from the smaller mid-tier firms. The two issues combined appeared in 30 (45%) of the interviews.

In relation to the Big 4 there were some (13 instances) who felt they were different. In these cases they tended to relate to what these people experienced through a proposal process or from a previous proposal which they then attributed to the firm as a whole. Their opinions concerned, for example, one firm being more prestigious or more formal, more flexible or centrally controlled than others. There was no consistent pattern as to which firms were considered to be associated with which attribute.

In contrast there were ten references to companies explicitly *not* seeing differentiation between the Big 4 firms. For example:

*[Chair of Audit Committee] felt each firm put its ideas across in its own way but that whilst there may superficially be differences in style and detail the substance for the Big 4 .....was pretty much the same in quality and product. All of the Big 4 are good at what you do.*

So, the evidence suggests that whereas some individuals saw the firms differently, there was no consistency in how they might be different; and others saw them categorically as not differentiated generally.

The position was much clearer in relation to differentiation of the Big 4 from the smaller, mid-tier firms. There were 13 interviews which contained references to the next or mid-tier firms. In most of these cases, these firms were excluded because the view was held that they would not have the capability to do the work; in some instances specifically associated with views about the weakness of their international networks or lack of experience auditing FTSE 350 companies. In some cases this appeared to be based on pre-held views, in others following pre-qualification assessments. Where these mid-tier firms were involved in the formal process, in most cases they performed less well and/or withdrew. This area is perhaps best exemplified by the following reference:

*[CFO]: The process was limited to the Big 4. There doesn't seem to be a middle tier. They felt they ought to look at the middle tier but there wasn't one. It was pretty clear to [Company] that they would be the biggest client by a factor.*

So, companies often appeared not to be differentiating or at least not differentiating on any consistent basis between the Big 4 firms *specifically*. What they were doing was differentiating between the Big 4 as a group and the mid-size or smaller firms.

There were however three areas where companies did seem to be differentiating between the Big 4 *in the context of their own needs* in specific individual tenders. These were industry experience and expertise, geographical strength in depth, and conflicts and independence. Each of these is now discussed further.

### **Industry experience and expertise**

By far the highest number of references in the interview data concerning firms related to industry experience and expertise. Thirty (45%) of the interview records mentioned this.

At the firm level a relative lack of industry experience was identified as excluding firms from tender processes or damaging their chances of success. Industry experience was identified both as important and, when present, was identified as a positive influence on the decision.

*[Chairman]: [Audit firm] had slightly more [industry] and European network credentials and these were finely balanced against the risk of change but [the company's executive team] felt that on balance they would gain more from having a more experienced [industry] audit team, it would give them more options.*

It was however also identified in a small number of cases that companies were concerned that an individual audit firm had *too much* experience. There were concerns where a firm already had a number of clients in the same sector or was just considered to be too big generally. The principal concern here was whether the company would really receive good service because it may not be a priority for that firm. The following interview record illustrates this point:

*[Group Financial Controller]:[Company] would be an important client for [Audit firm] – biggest client [in Company's industry] in the UK – get the best team. With [Incumbent audit firm] they were one of many. As they were*

*not number 1 this had to affect service levels. The issue was not about [industry] expertise – they hadn't seen much of that from [their incumbent audit firm] – it was about commitment to service*

In some cases industry expertise might also be regarded as a negative when it concerned an audit firm's relationship with a specific competitor of the tendering company. In four interviews companies had indicated concerns that particular firms audited their major competitors. In one case this had led to a firm being excluded from the invitation list and in another a firm being excluded quite early in the process. In one case the concern related to non-audit services where a company did not want its auditor to be acting for a competitor in a potential company acquisition that it too was considering (as noted in Chapter 2, the factors weighing against industry concentration within audit markets were discussed by Kwon, 1996).

So industry experience was the most commonly discussed attribute of the firms. Geographical strength in depth was the next most commonly discussed and is considered next.

### **Geographical strength in depth**

Although mentioned less than industry experience and expertise geographical strength in depth was highlighted in 15 interviews (23%).

In a substantial majority of these cases (11 instances) the concern was the international dimension. This included consideration of the firm's global coverage, and its structure/organisation. A number of interviews within this



group were concerned about even the Big 4 firms' presence in emerging territories such as Asia and Eastern Europe. In other cases references were less specific and about considering the global coverage of the firms more generally.

In many cases, strength in depth was also related to the firms having relevant industry experience in the right locations, but in other cases the comments were made more generally.

In three cases, the strength in depth was present as a factor in relation to UK regions. In these cases the presence of the right listed company experience and/or industry experience were the issues highlighted.

### **Conflicts with other services and independence**

In the previous sections the influences of firms' competences and capabilities relating to industry expertise and geographical strength in depth were identified. This section also highlights that companies were not only assessing the capabilities and competences that the firms had; they were also keen to ensure that they would get the benefit of these capabilities and competences through receiving the right priority service. This section considers data from the interview records which deals with the special circumstances associated with auditor independence which can create problems for companies actually wishing to access capabilities and competences from the Big4 audit firms.

As referred to in Chapter 1 and again in Section 4.2.2, in the aftermath of the collapse of Arthur Andersen the nature of the relationship between FTSE

350 companies and their auditor became much narrower with significantly heightened concerns over perceived independence threats. This made FTSE 350 companies very sensitive to the level of non-audit work they gave to their auditors.

Conflicts of interest were referred to in 14 interview records and three principal issues were identified.

Firstly, there were conflicts with non-audit services that the firms were providing and companies valued and wanted if possible to continue to have access to them in the future. In one record the issue identified was a service that couldn't, by regulation, be provided by the auditor; namely internal audit. In another it was tax service which could be provided but which the company preferred to keep separate.

Secondly, there was an influence in relation to non-audit services that had been provided by a potential auditor in the past. In one case a firm declined to tender because it could not meet auditor independence rules as they related to self-review risk as discussed in Chapter 1.

Thirdly, in one case a firm declined to tender because a partner in that firm had been employed as an adviser to the company.

The influence of conflicts on auditor selection means that where it occurs firms affected can be excluded from the process (or their chances of appointment reduced) and there is then a corresponding reduction in choice available to the company conducting the tender.

In one case the interview records show comments from a Group Finance Director following a change of auditor and relating to the former incumbent auditor of the company:

*...the proposal loss might actually be “liberating” for the relationship in that [the company is] determined to continue their split between audit versus advisory services. He thought that in a strange way this might end up being a better decision for [the outgoing audit firm]*

What he meant by this was that the opportunities for non-audit work were far greater than the value of the audit fee to the firm. Freed from the auditor independence regulations, the outgoing auditor may well be able to develop a more extensive non-audit services relationship than the audit in this case.

This concludes the Phase 1 consideration of the influence on auditor selection of the attributes of the firms. The next section considers the influence on the auditor selection decision of the assessment of the proposed lead partner.

#### **4.4.3. The lead partner**

Lead partner has been separated for consideration from the rest of the team given the prevalence of mentions identified in relation to them. The interview records highlighted a focus on the lead audit partner which was referenced in 38 (58%) of the records.

There were ten interviews which included only general comments about whether a particular lead partner was strong or weak. However there were also more specific comments which may be divided into three groups; each of which

occurred with similar frequency. These were the fit of their personal style with the organisation conducting the tender (15 instances), the experience of the audit partner (14 instances) and how effectively they would be able to deliver the audit service (13 instances).

In consideration of personal style, companies were interested in how well individual partners would work in a way that was consistent with their preferred way of working and their expectations of how a lead partner ought to behave. This included their style in communicating clearly and confidently, delivering tough messages, “telling it like it is” and standing firm. In addition confidence, personality fit and pragmatism were also identified. The following extracts from the interview data capture the spirit of much of the data:

*[Audit Committee Chair]: [Lead Partner] is [Lead partner] – I like his style – I’m looking for the meat of it – audit committees on the whole want to know about issues*

*[Audit Committee Chair]: The partner sets the tone.. the partner is important... there are tricky situations where you want your auditor to stand firm*

*[Group Financial Controller]: [Partner] is seriously impressive...back bone...tell it like it was*

Lead partner experience attributes discussed included that of the relevant industry, accounting and audit technical knowledge and experience of working with FTSE companies. However most referenced was industry knowledge and

expertise (10 instances). The interview records showed references to positive reactions when lead partners had industry knowledge for example:

*[CFO]: [Audit lead partner] had just rotated from [Industry leading organisation] and his significant industry knowledge was a big mitigating factor against any fears they may have had of risk of change. The industry knowledge was palpably there.*

And concern was identified when it was not there:

*[CFO]: [Audit lead partner] didn't bring the [specific] industry expertise – he wasn't in the [industry organisation] – no doubt he was in whatever the [other industry] equivalent of that was.*

The ability of the lead partner to deliver the audit service and to access the skills and experience of others was the third influence discussed. This was present in general comments about the partner's ability to deliver (5 instances), for example:

*[CFO] said that he and [Group Financial Controller] had joked that [Audit firm] were the Rolls Royce bidder and they had a vision of [Lead Partner and Lead tax partner] sitting in the passenger seats knowing they could mobilise everything they needed, and they did.*

And in more specific references including: the lead partners' leadership ability, their relationships in the company and connections outside, and their ability to deliver their firm. An individual reference was also made which connected personal style with ability to deliver. Here it was argued that if the

audit team liked working with a particular lead partner they would therefore be more likely to deliver a better service working for him.

Further evidence of the importance attached to the lead partner was also identified in relation to partner rotation (11 instances). Chapter 1 discussed the regulatory requirement which require the lead audit partner to rotate off FTSE 350 audits every five years. In some cases the partner rotation triggered the audit tender. In others the inability of an audit firm to put forward a strong enough alternative appears to have severely damaged their chances of winning the tender and so retaining the client. For example:

*[Chair of Audit Committee] felt the critical element [in a tender involving consolidation from joint auditors to a sole auditor] was that the [Lead audit partner on one side] was “time expired” [had served a full five years]. [CAC] knew the [Lead audit partner on one side] well – he works on another company where [Chair of Audit Committee] is on the audit committee but he couldn’t carry on. [Lead partner on the other side] was not time expired [had to rotate off in line with regulation as set out in Chapter 1].*

In this case the unavailability of a specific lead partner was the critical factor as to why that partner’s firm was unsuccessful in the tender.

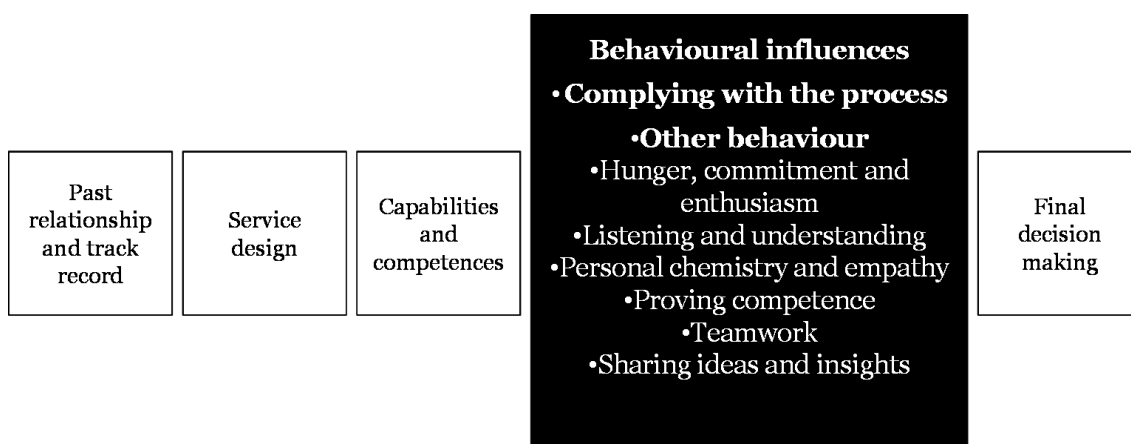
Finally in one case the relationship between the lead audit partner and the company was so strong that it was suggested that the decision to change auditor was at least in part made so that the company could continue to work with that person in a non-audit service relationship when he had to rotate off the audit.

This concludes the discussion of the third higher order category identified from the Big 4 firm's interview records. There is evidence of decisions being influenced on three levels; the team, the firm and the lead partner. Across the three levels there was most discussion on industry experience although geographical considerations around location of lead office and strength and depth were also identified.

The fourth factor group related to behavioural influences during the proposal process and this is discussed next.

#### **4.5. Behavioural influences during the tender process**

In Section 1.4.3 the nature of audit tenders for FTSE 350 companies was discussed and in particular the typical extensive nature of the process and the high level of interaction normally associated with such tenders. In Chapter 2 the influence of behaviours as cues on buyers of professional services with high credence qualities was highlighted. Important behavioural influences on decision making were discussed. This section discusses the references to behavioural factors identified in the interview records



The interview records included a high number of references (610) across almost every source (94%). And although the limitations on using interview records in this way were identified in Chapter 3 there was in particular a rich variety of behavioural factors. These are grouped in Table 16 which also shows the number of sources and references which were assigned to each subcategory.

<b>Factors</b>	<b>Sources</b>	<b>References</b>
<b>The quality of response</b>	<b>48</b>	<b>183</b>
<b>Other behaviour during the tender process</b>	<b>60</b>	<b>415</b>
• Hunger, commitment and enthusiasm	50	149
• Listening and understanding	35	74
• Personal chemistry and empathy	33	62
• Proving competence	32	56
• Teamwork	31	49
• Ideas and insights	15	23

Table 16: Phase 1 sources and references for Behavioural influences

These categories are now discussed further in turn. The way that these factors were manifest in the interview records is again illustrated on an example basis using references.

The first section discusses the influence on auditor selection of the quality of the responses to the invitation to tender and includes respecting and complying with the request for proposal.

The next six sections then consider the influence of more general behaviour on the auditor selection decision in descending order of the number of interviews that discussed them. The six behaviour groups included here and as set out in Table 16 are hunger, commitment and enthusiasm, listening and understanding, personal chemistry and empathy, proving competence, teamwork, and sharing and testing ideas and insights. As Table 16 shows and the next sections highlight, behavioural influences during a tender process



extend considerably beyond simply delivering a compliant tender response; indeed other more general behavioural influences were discussed in the interviews far more extensively.

#### **4.5.1. The general quality of response**

The general quality of response is considered here in each of the three principal elements of a typical proposal process and in descending order of the number of interview records which mentioned them, namely; the proposal document, the presentation and the meetings during the process.

##### **Proposal documents**

The quality of the proposal documents submitted by the firms was discussed in 39 (60%). Comments from the interviews about the importance of the document to the final decision are included in Section 4.6. Interestingly there were slightly more interviews that discussed the design and production quality of the documents (22 instances) than the content quality and clarity (19 instances).

The comments made about design and production included expressed views about whether one document or more than one as a package was most helpful, the overall print and production quality and the colours that were used. In a small number of cases some approaches to production and design were considered “quirky” although in the majority of cases documents were considered to have been professionally and well put together.

References to the quality of content included both its relevance and the clarity with which it was presented. In this latter case most reference was made to the succinctness of messages and the clarity of the language used.

The interview records contained nine references to companies commenting on the degree to which the proposal documents complied precisely with the request for proposal (e.g. responding to the requests contained in the invitation to tender in the order in which they were set) and therefore how easy it was to check this against their requests for proposal.

Companies also commented positively on the effort that had been put in to produce a high quality document and the clarity of message. For example:

*[Audit Committee Chair]: [Firm x]'s was good document. There was evidence of depth of experience to cover the bases but it was less detailed and more generic than [Firm y]. This reinforced the impression that [Firm y] had done a lot of work to get the job. Their document was very detailed and gave the impression that they would be very hands on.*

The interview records therefore provided evidence of companies valuing good documents and complying with the request for proposal.

### **Presentations**

The final presentations were discussed in 35 (52%) of the interviews. There were three themes within this group.

The most common discussion was about the style of the presentations (23 cases). Within this group the areas discussed included the degree of formality

adopted by the competing firms, the degree to which they were structured or unstructured and the use of technology or other props. In one case a firm had attempted to use an interactive game which had caused amusement (but not offence) when it didn't work properly. There were six interviews which highlighted a positive response to a discursive style.

The overall quality of the presentations was also discussed in fairly general terms (16 instances). In most cases there was positive comment but in a few cases companies expressed frustration that the presentations had not adequately supported the propositions that the firms had put forward in their documents and meetings.

In 12 cases companies talked about the degree of preparedness of presentations. In most cases companies felt the firms were well prepared and the word "polished" was used in a number of different interviews. In some cases the degree of preparedness caused amusement as companies observed behaviour that they thought had obviously been coached.

### **Meetings**

The meetings which took place during the process were discussed in 17 interviews. Companies commented positively on proper organisation and preparedness for those meetings. The following illustrates for example the importance that one company attached to agendas:

*ACC: The company was very impressed with the sheer thoroughness that [Firm x] demonstrated in this process. It was acknowledged that the process*

*presented a significant logistical challenge and [Firm x] covered it very effectively. [Firm x] went to meetings very well prepared [with] good agendas [and] worked through details*

### **Respecting the process**

The high profile nature of the auditor selection decision was discussed in Chapter 1 and evidence of companies investing to make sure that processes are conducted in a professional and fair way is presented in Section 4.6 below. In this environment the number of interviews which discussed whether the competing firms respected the tender process and followed the spirit of the process was perhaps quite low at 11 (17%) instances. However where this was discussed, companies in most cases expected the firms to operate within the rules of the tender and reacted positively when this happened. Where attempts were made to go outside the process, by organising contact with people not on the tender list, or by trying to arrange additional meetings, these were normally prevented or viewed negatively.

There were some exceptions that showed that not every company was so strict. Some tolerated firms challenging the process or even not complying in certain ways within reasonable tolerances because they thought it indicated particular enthusiasm, for example:

*After the initial meeting ...there was a shut out period while [Company] completed its year end. During this period the only permissible contact was a fortnightly call with [Group Financial Controller]. [One] team had complied with the rules but had actually come closest to not complying. "They gave the*

*feeling of enthusiasm” – just crept over the line “on a couple of occasions”  
“minor point” “much further and would have got “hang on”.*

In four cases companies reacted negatively where they considered the firms’ behaviour to be inauthentic or not in keeping with the spirit of the process. One firm had attempted to support its key propositions by using large polystyrene blocks which was seen as a negative as the company felt this was an indication that that firm was making light of what they considered to be a serious process.

In this section and the previous one, discussion has been about influences on auditor selection related to the quality of their performance in relation to the documents submitted, the presentations and the meetings and how well firms respected the tender process. The interview records provide evidence of companies valuing proper preparation in relation to both meetings during the tender process and in the final presentation. Furthermore the interview records also show companies valuing compliance with tender rules with limited tolerance of firms breaking the rules in how they complete the process; further there is evidence of companies valuing documentation which complied with the request for proposal

The next six sections now discuss more generally the behavioural influences on auditor selection identified from the interview records. As will be shown the level of discussion in these areas was substantially more than that about the quality of response.

#### **4.5.2. Other behavioural influences**

The interview records included substantial comment in relation to behaviour which went beyond simply meeting the requirements of the tender with a high quality response. As the following sections show, although there was evidence of companies testing firms on their propositions and competence much of this appeared to involve highly affective matters. The first of these was companies looking for firms to demonstrate hunger, commitment, enthusiasm and desire to win the work.

##### **Showing hunger, commitment, enthusiasm and desire**

Hunger, commitment, enthusiasm and desire was the most frequently referenced category within behavioural influences and was present in 50 (75%) of the source interview notes. Companies recognised in particular, and commented favourably on, the high levels of effort and enthusiasm that firms were investing in proposals (21 instances).

The favourable impression created by hunger, commitment, enthusiasm and desire was manifest in a number of different ways.

The overall level of effort put in by lead partners and their teams was noticed both in the proposal process and in the effort put in to create high quality proposal documents (this latter point is returned to in Section 4.5.1). The following examples illustrate this point:

*[Director of Finance] felt [Firm x] had called the stage 1 process exactly right. [Firm y] had not. The enthusiasm came through from [Firm x lead*

*partner] right from the start. [Company] had set out a minimum proposal requirement but significantly greater effort than expected had been put in by [Firm x]*

A favourable impression was also created not just by the overall level of effort but also in such areas as speed of response to tender requests, pro-activity and even in one case, passion.

Companies also noticed how quick the firms were to respond to the initial request for proposal in particular and expressed concern where that speed of response was comparatively slower; on occasion interpreting this as lesser desire to win the audit.

Companies also referenced favourably the level of pro-activity demonstrated by the firms during the proposal process. This was present in general comments, in summaries of proposal processes prepared by those managing the process for audit committees and in one case as an explicit assessment criterion.

There were a number of instances of firms going beyond the process and providing things that companies had not asked for. This included highly designed and high quality printed documents, creating bespoke dedicated websites and delivering video footage of the team.

The role of very senior partners (often members of the firms' management teams) was also a prevalent area of discussion (32 instances). Companies' reactions to this however varied. For some the involvement of a very senior

partner was welcome as was the degree of interest. Furthermore where there had been problems in the relationship between the company and the proposing firm, the involvement of a very senior partner was positive as it helped to repair the position. In other cases however the involvement of senior partners was not well understood. For example:

*[X Firm Chairman] had also contacted the SE Asia CFO to offer resources to help with [the company's] growing pains. A call was made directly by [the Firm Chairman] to the CFO. This didn't really work as the CFO didn't know who he was talking to until the end of the call and then stood up and saluted!*

In other cases companies specifically asked for senior partners not to be involved unless they were on the service team. This was not always respected and as a result when these senior partners appeared it caused annoyance.

### **Listening and understanding**

Listening and understanding were recurrent themes in the interview data. In total 35 (53%) of the 66 interview records referred to them.

The positive influence of demonstrating understanding was highlighted in 21 interview records. The most often referenced area of understanding relates to understanding of the company's business (13 instances) (this is consistent with the emphasis on industry experience and expertise noted in the discussion of competing firms' capabilities and competences discussed in Section 4.2 above).

Business understanding was referenced for example:



*[Audit Committee Chair]: [Firm x] demonstrated a much better understanding of the detail. Their media credentials were helped by the fact that their local manager had previously worked in radio.*

*[Audit Committee Chair]: [Firm x] had got more into the soul of the business and this is what swung it for them.*

Within the topic of business understanding, the importance of understanding risk was also specifically referenced with comparative statements as to how well firms had shown their understanding in this area.

References were also made to understanding client culture, understanding client needs and understanding grey areas.

Listening was referenced in 19 of the interview records. The interview notes identified the positive influence of listening. References to listening were made generally such as:

*[CFO]: [Firm A] came in and listened and demonstrated depth – made suggestions up front – had confidence*

In addition and although there were a number of references to how well firms had listened these were also in most cases associated with a responding action. For example in eight instances listening was associated with a subsequent change or enhancement of the proposed team. In three further instances the positive influence of firms being seen to be trying to respond to what they had heard in specific areas was also identified. So it was not just about listening it was also about an effective response.

In seven instances companies highlighted how firms had specifically sought feedback on how they were performing. This feedback included the teams seeking comments as they progressed through the proposal and also contact from senior partners within the firms not directly involved in the proposals.

The third area was focus on the right things; those of relevance to the companies (11 instances). This included focussing on the company (rather than their own firm), and identifying and discussing all the important issues, focussing on the key issues as the companies saw them and not talking to services which were outside the scope of the tender.

The demonstration of understanding and listening and responding were then identified as behavioural influences on auditor selection. The next set of influences concerned the personal interaction and chemistry.

### **Personal interaction and chemistry**

Personal interaction and chemistry was referenced in 33 (50%) of the interview notes. There were a number of different ways in which this was expressed. The highest number (eight) were looking for people they could work with, for seven others, people talked explicitly about including personal chemistry in their consideration of perspective auditors. Five others commented on the personalities of the teams whilst three others talked about rapport. Other comments included whether people were comfortable with each other, how well the teams fitted in and how easy they were to relate to.

The following extract illustrates the overall point :

*[CFO]: the relationship has got better as we've worked together. There's never been a problem that we haven't been able to resolve.*

*It became for [CFO] [about] can I work with these people? Am I going to look forward to ringing these people? Who am I going to be dealing with?*

Other positive influences on auditor selection included demonstrated authenticity and integrity (four instances).

Conversely there were also references to behaviour which was not conducive to good personal chemistry. This included trying to use the proposal to sell other services (three instances) appearing arrogant, overpromising, taking credit for the work the company itself was doing and lacking empathy.

Interestingly many of the comments recalled individual instances of good or bad behaviour. For example in one case a senior manager was considered to have “scored a number of spectacular own goals” by talking about expensive restaurants that he had frequented. The finance director in this case reflected on his last Chinese meal indicating his feeling that the individual had completely misread the company's culture.

### **Assessing and proving competence**

Section 4.4 discussed the interview record evidence concerning what competences and capabilities were being sought by those selecting an auditor. The interview records contain considerable evidence of this being assessed during tender processes with 32 (48%) of the source records containing

reference to it. The most common facets were comments on the general quality of the performance of individuals (12 instances) and on the demonstrated strength and depth of the team (nine instances) .

The vast majority of references in relation to individuals related to their performance in the final presentation with references evenly split between those referring to the team as a whole and those relating only to the lead partner or the lead partner and working partner.

Similarly of the nine references to depth these were predominantly about how well this was demonstrated in the final presentation, by for example the strong presentations of the whole team or specifically by bringing overseas partners to it.

A further four interview records contained references to how well teams performed in the question and answer sessions as part of final presentations.

The predominance of the presentations in commenting on behavioural performance was also a feature of measuring teamwork as is referred to next.

### **Teamwork**

The interview records also provided evidence that companies were not only noticing how the firms were interacting with them, but also how they were working with each other. In total 31 (47%) of the interview records contained references to who came to various meetings (and in particular the final presentation) and how they interacted.

In common with assessment of competence, the vast majority of the references related to how teams structured and worked together in final presentations (18 instances), the balance of performance within the final presentations (eight instances) and more explicitly on the teamwork that was demonstrated (five instances).

### **Presenting and testing ideas and insights**

Presenting and testing ideas and insights were referenced in 15 (25%) of the interview records. This section is of course closely associated with consideration of these matters as part of the future service design outlined in Section 4.3.4. However the Phase 1 analysis not only identified these ideas and insights being valued as part of the future service design but also the act of raising them during the proposal process being influential.

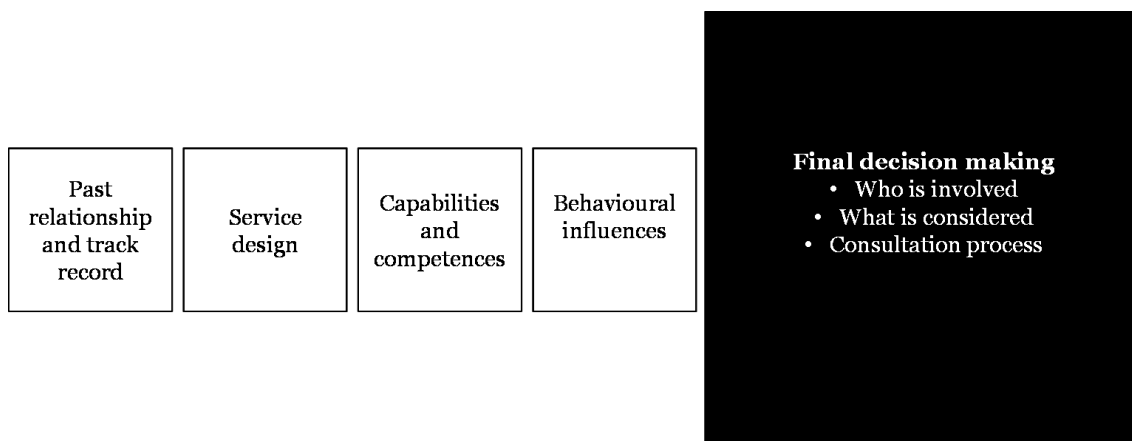
Companies commented favourably where firms demonstrated insight into their industry and geographical markets, about the current and emerging issues facing them and about the companies themselves.

There were a small number of comments about new ideas including how the firms' audits might improve the company's reputation and even its share price. Other ideas included suggesting the use of software in an innovative way in the audit.

Companies however did want to hear about ideas at the right time. A suggestion for an improved relationship with internal audit was badly received by the head of internal audit and the audit committee because they had not

heard of the idea until the final presentation and it had not previously been discussed with them.

#### 4.6. Final decision making



In the previous sections the focus has been on evidence from the interview records of influences on the auditor selection decision arising from the relationships which existed before the tender processes and from facets of the service propositions that put forward (service design) of the firms and the teams put forward (their capabilities and competences) and elements of the way they behaved during the tender process.

The final factor group is final decision making. There was evidence that companies were committed to conducting fair and proper proposal processes (13 instances). References were made to investing time in the process and making time for firms to meet key people (five instances), a structured process (three instances), an extensive process (two instances) and a real process (two instances). Companies also identified that they had not tendered the audit for a

long time (nine instances) and that they thought it was the right thing to do either generally or following corporate governance (eight instances).

In every case, the formal and final decision on auditor selection was made at the end of the process and normally following final presentations received from shortlisted firms, although some companies chose to shortlist down from their original invitation list based on firms' performance during the proposal (normally after submission of a proposal document).

In arriving at a final decision a discussion took place which considered the process overall. This final factor group therefore relates to the nature of the final discussion that took place, what aspects of the process were given weight, and who was involved. Matters relating to decision making were identified in 62 (94%) of the interview records.

The numbers of sources and references for each of these subcategories is set out in Table 17 and then each is considered in turn.

<b>Factors</b>	<b>Sources</b>	<b>References</b>
Decision elements and their weight	51	159
Decision consultation	50	118
Decision makers	47	109

Table 17: Phase 1: sources and references for Final decision making

#### **4.6.1. The decision elements**

The interview records contained a lot of evidence about how the various stages of the proposal process (for example meetings and feedback, proposal documents and presentations) were considered in final decision making. This was identified in 51 (77%) of the interview records.

Within this group, 31 interview records included references to a decision developing during the process. As noted above there were ten instances where a formal shortlisting from the original list, normally from three or four firms, to two took place. In most cases however companies seemed not to have fixed views on the likely outcome until the final discussion (which is not to say that they did not have preferences – for example the challenges facing incumbent auditors were discussed in Section 4.2.1). The potential for expectations to change was highlighted by examples of incumbent auditors overturning difficult positions at the start of the tender process, challenging firms overtaking incumbents during audit tenders, different firms being ahead at different stages of the process and firms being ahead but tripping up. A reference attributed the Finance Director of one company illustrates the point:

*The decision didn't emerge however until after the presentations when the committee discussed all four tenders. In a fluid process all had probably changed their minds at least once.*

A measure of the dynamics of the final auditor selection decision is provided by the relative influence of different parts of the tender process. This may be divided into three parts: meetings, documents and presentations.

There were 18 interview records which referred to gathering feedback from meetings during the tender process and responses were coordinated centrally and in some cases summarised. A further 11 records referenced specifically the use of score sheets and weightings. Generally the records referred to feedback forms with specific questions which were then supported by more informal



discussion. The forms were seen a guide rather than being designed to create a numerical result. There is evidence of the feedback from meetings being very influential in the final decision, but also of firms coming second or third still being appointed.

The interview records evidence concerning the influence of proposal documents on selection decisions was mixed. Although five interview records referenced the importance of proposal documents as a means of obtaining information, particularly for non-executives, both for informing and reassuring that an appropriate proposal process was being undertaken, in 12 interview records there was evidence of their lack of importance. This lack of importance was expressed either relative to the other parts of the process or in absolute terms as is illustrated by a reference relating to a Group Financial Controller:

*[Group Financial Controller] reflected on how much time he had probably wasted whilst he was at [a Big 4 firm] in preparing proposals. He looked at the proposals and ten pages were enough. He doubted that others had really looked at them.*

In contrast there was no evidence of anyone thinking the final presentation was unimportant. In the 13 interview records that referred to presentations they were considered important; either as one selection criteria in their own right amongst others or in most cases as the culmination of a decision process that was still taking shape and was still in the balance.

#### **4.6.2. Decision consultation**

In Chapter 2 the role of affect and its particular influence where decisions are made in the moment was highlighted. Also in that chapter the power of group dynamics in decision making was considered. The nature and timing of the final decision and the way that the decision was reached in most cases in open discussion are consistent with both influences being present in auditor selection.

The dynamics of the final discussion were discussed in 50 (76%) of the interview records. The interview records provided evidence of a number of themes.

Firstly, decisions tended to be close, at least between the preferred bidder and the next best (27 instances). One CFO was recorded as having commented:

*...a length and a half separating the four runners*

An Audit Committee Chair was recorded as saying:

*... it was 50:50 but of course you can't have 50:50 so 51:49*

Secondly, decisions tended to be consensual between the selection panels. One CFO was recorded as commenting that it was a bit like a jury. In most cases in spite of the comment about the closeness of the assessment of the firms, a decision was reached in a relatively short time and straight after the presentations. Where there was disagreement there was evidence of airing of views and debate which was twice referred to as “long and hard”. There were

five instances where a decision was taken in principle but subject to follow up on areas of concern.

Thirdly, although the discussion tended to be chaired by the Audit Committee Chair in some cases (five instances) the decision either followed a management recommendation, or audit committees referred the decision to management having satisfied themselves that the alternative firms being considered were all acceptable. Where a decision couldn't be made, typically other members of the Board were invited to input (four instances) to help break the deadlock.

Fourthly, although companies had checklists and a number talked about going through the strengths and weaknesses of the firms and feedback from those met by the firms during the process, this did not appear to be decisive. For example one CFO was recorded as having said he:

*Looked at what the scores told me but I had no intention of following [them]*

The interview records therefore suggest that in spite of an evolving process, the final decisions were not being taken until in most cases immediately after the final presentation. The literature would suggest that with a decision so close to the final presentation the influence of affect on that decision may well be heightened.

#### **4.6.3. The decision makers**

It is the formal responsibility of the audit committee as explained in Chapter 1 to make a recommendation to the Board for subsequent shareholder ratification concerning auditor appointment. The interview records however showed that the ways that companies were interpreting that responsibility played out in different ways in practice. The construction of the decision making unit may be influential to the auditor selection decision given the different responsibilities of those involved especially between audit committee and management.

Most tenders had a selection panel which included members of the audit committee and group financial management. In some cases extended to include representatives of key operating divisions or other head office management such as internal audit or the company secretary. In some cases the selection committee was split with a management only committee reporting to the audit committee. In only two cases was there reference to the involvement of the chief executive (although in one case decisively as will be referred to again below). In only one case was there reference to a chairman being involved in the process.

There was in practice a range of involvement of the audit committee. In some cases having satisfied themselves that due process had been followed they had left the decision to management. In other cases they had received a recommendation from management which after final presentations they had accepted. The interview records identified two tenders where the audit committee concluded that there were two high quality proposals and referred

the final decision back to management. In one case the audit committee could not decide and the decision became one for the company's board as a whole and, in one case, the audit committee and management disagreed and the chief executive officer became arbiter. In a further case the feedback from the meetings process was so influential that the audit committee and management were content to go with it.

In some cases the decision making unit was much more narrowly defined including only the chair of the audit committee and the finance director and in one case the chair of audit committee and the chairman.

Before concluding the discussion of the influence of decision making processes on auditor selection it is worth considering the interview record evidence as it related to contextual influences on auditor selection.

#### **4.7. Summary and conclusion on Phase 1**

The literature review which was completed in Chapter 2 identified five themes arising from supplier selection literature and behavioural decision theory and certain other literature relevant to influences on decision makers. These were relationships and track record (at the start of the proposal process), service design, capabilities and competences (of the competing firms and teams), behavioural influences (during the proposal process) and final decision making.

This chapter has set out the findings of Phase 1 of the current research, namely the analysis of the post decision interview records provided by a Big 4

firm for the period August 2002 to May 2010. This analysis was conducted in accordance with the approach set out in Section 3.2.4 above and has identified the same five themes as factor groups.

The findings from Phase 1 also provide additional evidence as to how the auditor selection decision is likely to be working. In particular, they provide additional detail concerning the factors influencing auditor selection which lie below the five factor groups influencing auditor selection. They also provide challenge in some areas, where factors which the literature might suggest were influential, were not referenced.

### **Relationships and track record**

Within the relationships and prior track record factor group, the important influence of the relationship the company has with its incumbent auditor was identified. In this phase most companies conducting audit tenders had service problems especially around accounting issue resolution and (to a lesser extent) international coordination and communication. As well as putting the incumbent auditor at a disadvantage these sources of problems became service design objectives.

The research however also identified other factors inherent to the incumbent auditor situation which also put them at risk. These included changes in management and changes in companies more generally which caused companies to consider auditor change. Where incumbent auditors responded with proposals for service improvements they faced the challenge of “Why not before?”

Against these disadvantages were weighed incumbent knowledge and the potential risk and disruption associated with auditor transition; although the latter was also counteracted by the attractiveness of a fresh approach and detailed transition plans submitted by challenger firms. These were seen to mitigate concerns over transition.

### **Service design**

Phase 1 provided evidence that service design could be differentiated and companies were considering design including a core and an augmented service.

At the core, companies were valuing rigour and assurance in considering auditor selection whilst the augmented service consideration included facilitating services associated with the audit. These were coordination and communication associated with the audit, accounting technical matters (especially dealing with accounting issues), the approach to the audit of IT systems and controls and how auditors proposed to work with internal audit departments. Companies were also looking for ideas and insights from their auditors based on their broader knowledge and experience.

Fees were found generally not to be a major influence on auditor appointment. This arose either because the fee quotes were close, or because companies felt the fees unimportant as they represent a small proportion of total spend, or because negotiations took place after the decision or as part of the decision with the preferred bidder.

### **Capabilities and competences**

Capabilities and competences were found to be influences on auditor selection and operating at three levels: the firm, the team and the lead partner. For the firm the principal influences identified were industry experience and expertise, geographic coverage and dealing with conflicts.

The assessment of teams was being undertaken at the individual and team levels with industry experience and expertise again being highlighted. Companies were also keen to understand how the team was structured.

A focus on the experience of the lead partner, along with an assessment of their ability to deliver the audit, as well as their personal styles was also identified.

### **Behavioural influences**

A variety of behavioural influences was also identified. Whilst companies were assessing the quality of the responses made to their requests for proposal, including the quality of the meetings conducted, the proposal documents and the presentations, there was a much broader discussion of the influence of behaviour during the tender process and there was considerable evidence of affective influences.

The most referenced influence was hunger, commitment and enthusiasm and indeed this was referenced in slightly more interview records than the assessment of the quality of response. References to the importance of listening



(and responding to what was heard) and understanding and personal chemistry were referenced slightly more often than those relating to proving competence.

These findings may well support the fact that companies found it difficult to undertake assessments of the service provisions or felt that each of the firms could provide the same service and were therefore falling back on other interpersonal influences.

### **Final decision making**

Phase 1 identified that the final decision was typically not made until after the final presentation. In most cases this decision discussion immediately followed the final presentations although consideration was given to meetings including feedback from those not present at the final discussion, the documents and the final presentations.

In the majority of cases decisions were close but the final discussion consensual between the selection panels which included both non-executives and executives. There were instances of non-executives passing the decision to management once acceptable alternatives had been identified. Where there was disagreement, there was evidence of debate and discussion and where there was a deadlock, evidence of bringing in other Board members.

### **Relationships between the factor groups**

As set out in Section 4.0, Phase 1 formed part of a three phase approach to answer the research question:

*“What are the factors affecting the auditor selection decisions of  
FTSE 350 companies in competitive tenders?”*

The research design was therefore focussed on identifying influencing factors. During Phase 1 however a number of indications started to emerge about how these factor groups influencing auditor selection might interrelate. For example the track record of experience and in particular service problems were seen to focus service design around providing solutions to those problems especially, but not restricted to, accounting issue resolution. Similarly the experience that companies had prior to tender with competing firms, through non-audit service relationship and/or targeting, was taken as evidence of how firms were likely to behave in the future.

Capabilities and competences were identified as being assessed especially in the final presentation. Changes to the teams were also being made as a result of listening. And the lead partner assessment was being influenced by consideration of that person's style with clear references to the way that they behaved in the proposal process.

Service design was also being evolved during the process with tailored service and audit plans.

Although not directly part of the initial research design which was focussed at identifying influence factors (not their inter-relationships) they do provide an interesting additional aspect and are returned to in Chapter 5.

### **Introducing the initial conceptual model**

The initial conceptual model was developed reflecting the five order categories identified in Phase 1 and also took into account the contextual influences discussed in Chapter 1. Reflecting the literature which cast doubt over the applicability of normative models, the initial conceptual model therefore also recognised that each selection decision is likely to be influenced by the general experience and situation of the proposal.

The model also started to consider the indications of relationships which the factor groups influencing auditor selection might have with each other. The initial conceptual model is set out in Figure 11.

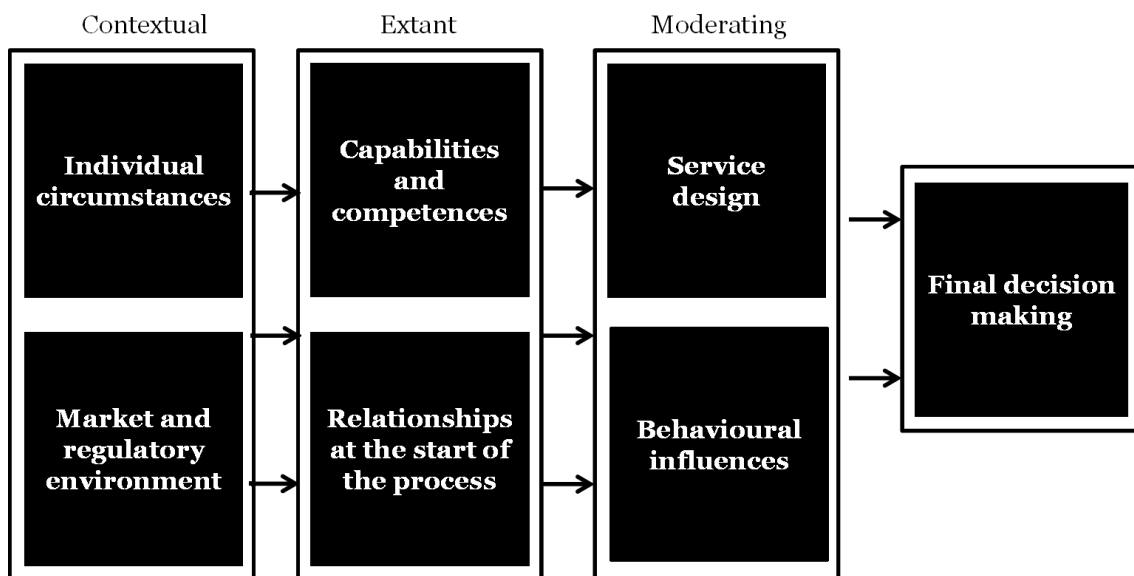


Figure 11: The initial conceptual model

The model was constructed based on the pretext that the auditor selection decision started with the context; being the individual circumstances facing those making the selection decision and the market and regulatory context.

Each decision would then start with some extant conditions. These related to the relationships that existed at the start of the selection process and the capabilities and competences that the competing firms and their teams had.

The activities that took place during a proposal process were then service design and other interpersonal contact. These were moderators of relationships and capability and competence because decision makers' assessments of these first two factors would evolve as the proposal process went on. They were also however decision influences in their own right because comparisons were being made between the service propositions and people were falling back on behavioural cues where they found the service propositions similar.

In the final selection all of these factors were influential and they would be processed in a final decision; the dynamics of which formed the final influence factor. The discussion and debate in the final discussion including the dynamic between those involved would shape the final outcome; especially as most decisions appeared to be close. This discussion typically took into account the whole process including meetings, documents and presentations, but whilst the documents were of variable importance, the presentations were seen more generally to be important.

As will be seen in the following chapters, the later phases of the current research suggested a different model with consistency about the underlying factor groups influencing auditor selection but some differences in their position and inter-relationships.

The initial conceptual model was however an important part of the research as it stimulated reflection in a more holistic way about the auditor selection decision. This is developed in the chapters that follow.

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**CHAPTER FIVE**  
**RESEARCH FINDINGS PHASE 2a:**  
**IN DEPTH SEMI-STRUCTURED INTERVIEWS WITH COMPANIES**  
**JUNE 2010 TO SEPTEMBER 2012**

**5.0. Introduction**

In line with the phased approach explained in Section 3.2 this is the second chapter of three which set out the findings of the data relevant to answering the research question:

*“What are the factors affecting the auditor selection decisions of FTSE 350 companies in competitive tenders?”*

In the previous chapter the findings of the analysis of post tender interview notes maintained by a Big 4 firm were discussed.

This chapter now sets out the research findings following the analysis of the in-depth interviews conducted with those within FTSE 350 companies who, at the time of the interview, had recently been involved in an auditor selection decision involving a competitive tender.

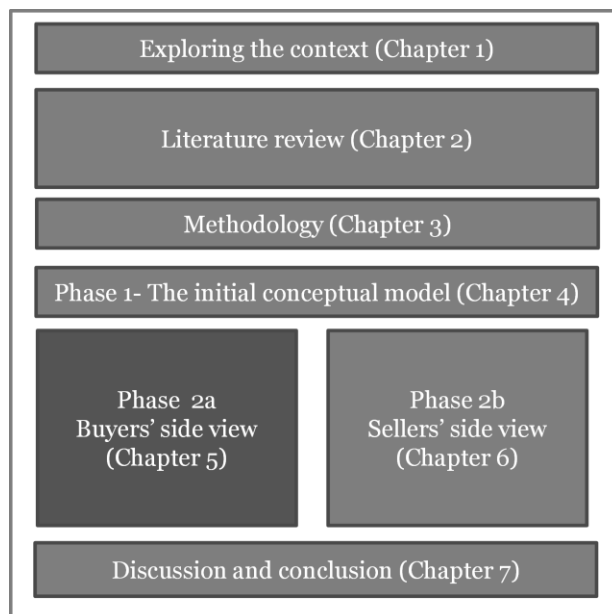


Figure 12: Phase 2a within the overall research approach

### **5.1. Analysis of in depth interviews with those involved in an auditor selection decision by a FTSE 350 company**

Consistent with Phase 1 of the study, the analysis was conducted in accordance with the research approach set out in Section 3.2.4 above. Across the 23 in depth interview records, 696 nodes were identified and 1709 references were assigned to these nodes (on average some 74 references per interview). The numbers of both nodes and references per source interview were much higher than Phase 1; consistent with the fact that Phase 2a was based on in-depth interviews and transcripts (or detailed cross checked notes) rather than the Big 4 firm's pre-existing post decision review notes used for Phase 1 (see pages 118-119 for more details). Reflecting the greater richness in the underlying data, additional issues were identified and some influence factors emerged with different slants and nuances.

In summary however, although the research findings analyses of Phase 1 and Phase 2a were conducted independently, in each case using the grounded approach set out in Chapter 3, there was a high degree of consistency in the findings at both the factor group and individual factor level, albeit as will be discussed below and again in Discussion in Chapter 7, there were some differences especially in balance between the phases.

As a result of the Phase 2a analysis a revised conceptual model was constructed which considered the factors affecting auditor selection.

The revised model followed detailed reflection based on the themes and knowledge emerging from the research as it progressed. As Figure 13 shows, this



post Phase 2a model contains the same five factor groups influencing auditor selection but, having been developed separately based on Phase 2a findings, takes a different approach to the relationships between these factor groups. Lastly the revised model deals with contextual influences in a slightly different way.

The conceptual model is set out below and explained in the subsections that follow.

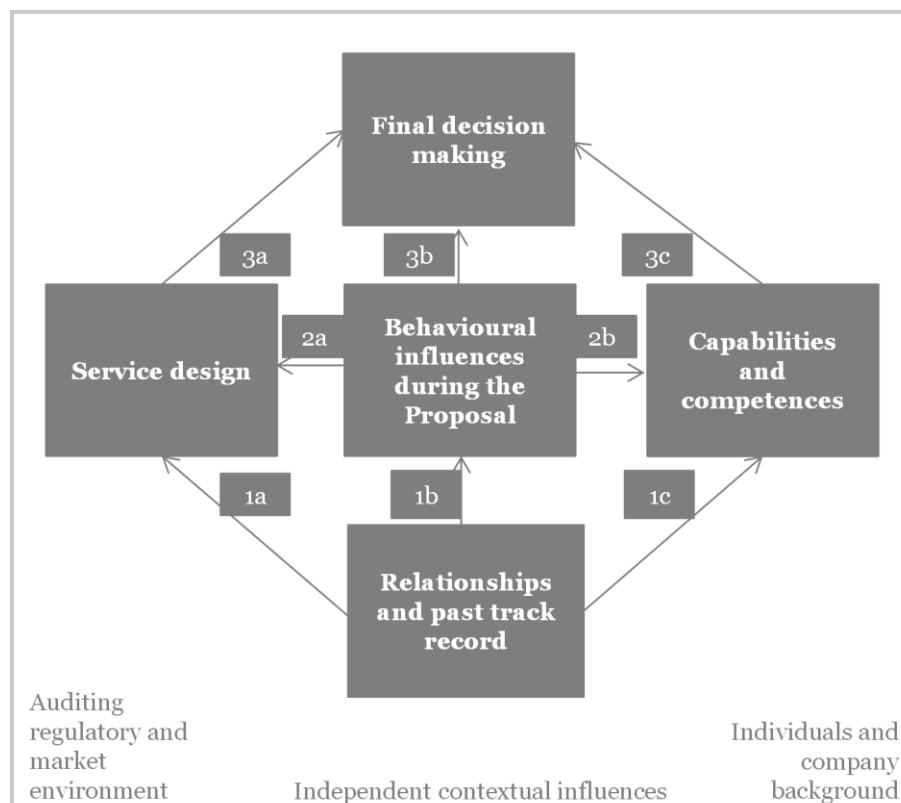


Figure 13: The revised conceptual model

Consistent with Phase 1, the five factor group influences on auditor selection identified were: Relationships and past track record (at the start of the proposal process), Service design, Capabilities and competences (of the competing firms and teams), Behavioural influences during the proposal process and Final decision making.

The principal relationships identified in Phase 2a were placed within three groups: firstly, the influence of Past relationships and track record on Service design (1a), Behavioural influences (1b) and Capability and competence assessment (1c); secondly, the influence of behaviour during the process on Service design (2a) and Capability and competence assessment (2b); thirdly, the influence of Service design (3a), Behavioural influences during the proposal (3b) and Capabilities and competences assessment (3c) on Final decision making.

The five factor groups influencing auditor selection are considered first, then the relationships between them.

## 5.2. Relationships and past track record

The generally long periods of auditor tenure, but also high switching rates within tenders, had previously been identified in the contextual review (Section 1.4.2) and confirmed by the current research (Section 4.3).

There was evidence that audit relationships often sustained but that once at tender, companies tended to switch.

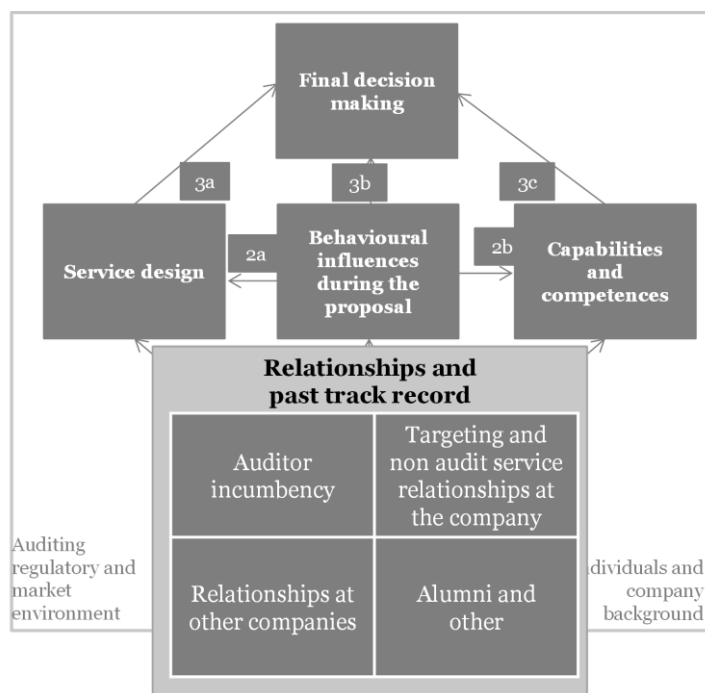


Figure 14: Relationships and past track record influences on auditor selection

The findings from Phase 2a showed considerable consistency with Phase 1, highlighting the relationship that a company had with its incumbent auditor, its relationship with other firms and the individual relationships that directors and senior management had with firms from past experience, cross directorships and past employment (alumni relationships) as the main influence factors. The number of sources and references for each of these is for Phase 2a set out in Table 18 below.

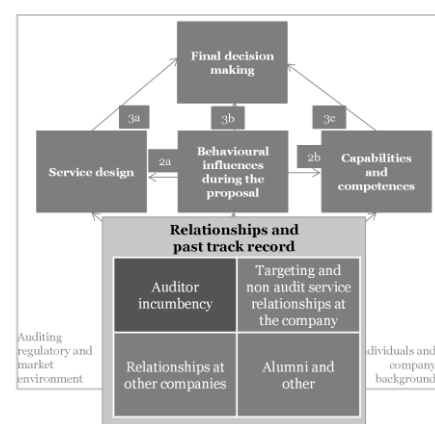
Factors	Sources	References
<b>Audit firm incumbency</b>	<b>23</b>	<b>180</b>
• Incumbent track record	20	75
• Incumbent inherent position	20	72
• Audit transition	14	33
<b>Targeting and non-audit service relationships</b>	<b>14</b>	<b>48</b>
<b>Relationships at other companies</b>	<b>12</b>	<b>35</b>
<b>Alumni</b>	<b>8</b>	<b>17</b>
<b>Trust</b>	<b>5</b>	<b>14</b>

Table 18: Phase 2a Relationships and track record sources and references by factor

The findings in relation to each of these subcategories are considered in the following sections.

### 5.2.1. Audit firm incumbency

Audit firm incumbency was discussed in each of the 23 in-depth interviews conducted as part of Phase 2a of the research and 180 references were identified. The discussions related to both the track record of the incumbent and its inherent position as a result of other matters at the relevant



company and at the relevant time. Considerations pertaining to audit transition are also dealt with here.

The track record of the incumbent is considered first.

### **Incumbent track record**

Phase 1 had identified past service problems, particularly those relating to dealing with accounting issues and international coordination. Within Phase 2a in comparison, the references to the track record of the incumbent auditors were much more balanced between positive and negative comments. Of the 20 (87%) source interviews which referred to the track record of the incumbent, 12 (52%) referred to past service problems but the same number talked about auditors doing a good job (NB in four interviews both problems and positive experiences were discussed). Accounting issue resolution which had been highlighted as a common problem in Phase 1 was only discussed in one interview.

The change in balance between positive and negative comments was directionally consistent with a change in the reasons people gave for the tender. In Phase 2a ten interviews (44%) indicated that corporate governance or a feeling that best practice required a tender had been a driver of the proposal (this compared with only 25% in Phase 1 where dissatisfaction had been identified as the most common driver).

The reduction in the level of problems associated with accounting issue resolution and the increased influence of corporate governance may well be due

to the later time period covered by Phase 2 as compared to Phase 1. This is returned to in Discussion in Chapter 7.

In Phase 2a there was however a variety of other issues which gave rise to a poor incumbent service record although none of these occurred more than a small number of times. In addition to general comments about dissatisfaction with service and relationship problems these specific issues included:

- issues not being communicated effectively from an important overseas subsidiary ( two instances) or in another case where a company felt it was receiving poor quality reports;
- problems with the rotation of a lead partner (in accordance with the mandatory maximum tenure periods for lead partners explained in Chapter 1);
- a disagreement about a specific issue or event which became problematic (for example disagreement about a major governance issue);
- a relationship that had become stale such that company no longer felt it was getting good service or a service that was no longer right for them such that they questioned the value that was being delivered by their auditors;
- concern over the approach that the auditors were taking, when for example, the company felt that this approach was not recognising their own investment in systems and controls or that recommendations for improvement were not constructive *“beating us over the head”* (one instance each);

- where companies felt their audit fees were too high; and lastly,
- in an otherwise good relationship, a tender and change were triggered when a company's incumbent audit firm decided to propose for the audit of one of its competitors (supporting the preference for companies not to be audited by close competitors identified by Kwon (1996) and discussed in Chapter 2).

So there were a variety of situations that could give rise to perceived service problems for incumbent auditors. In some cases, the comments related to issues which, of themselves, did not seem sufficiently serious to merit a change in auditor. Companies seemed to be prepared to tender with fewer, less serious or indeed any problem with their incumbent. One financial controller commented:

*“We haven’t done it [tendered] for 23 years so we don’t do it often, we don’t do it lightly. Was it a criticism of [incumbent firm] team, no, but did they light us up and make us feel special and deliver stuff, no not really and to be honest it was probably a bit of a journey...”*

As noted above, Phase 2a identified 12 instances where companies conducted an audit tender in spite of positive comments about the past service track record of their incumbent. In eight cases interviewees referred to their auditors doing a good job generally. In addition interviewees talked about commitment and investment in the relationship, good balance in the partner team, evolving the relationship and moving partners around their group globally. So consistent with more corporate governance driven processes, more

audit tenders were being started even with apparently good service relationships.

### **The inherent position of the incumbent**

Comments in relation to the inherent position of the incumbent were also quite balanced with those highlighting advantages (14 instances) comparing broadly with those discussing disadvantages (11 instances).

In 14 interviews references were made to the inherent advantages that an incumbent auditor possessed. In most cases these related to that auditor's knowledge and understanding of the company, its business and its people (11 instances). These references were not always however entirely straight forward. For example, although acknowledged as an asset, one Group Finance Director talked about how his company had *not* selected their incumbent firm which is what they had expected to do, given their knowledge of the business. In another case the potential value of knowledge was noted but it was felt to be outweighed by other factors.

Incumbent knowledge appeared most persuasive when it was used effectively; translating into behaviour during the process. In one case a Group Finance Director talked about how the incumbent had demonstrated greater understanding of the company in their presentation. In another they had tailored their style:

*[CFO] "I think [incumbent firm] knowing us extremely well, this was their presentation, really light....[they] are saying look we know these guys ,*

*they don't like [messing] around, they like getting on with things and this is all they need to come to views and a decision. So I think this lighter version for us was absolutely right"*

Companies also valued the knowledge they had of the audit team and firm and its strengths and weaknesses (accepting that this would not always be positive). A benefit for the incumbent was therefore that they constituted a "known entity" (four instances).

Amongst the inherent disadvantages for the incumbent there were cases of new management driving tender processes (four instances), and recognition of general change in the business de-stabilising an audit relationship (three instances). A number of more specific risks to an incumbent were also identified.

Firstly, companies felt that it was easy for an incumbent to be complacent. Where the same people were discussing the same issues the repetition could become both boring and frustrating (even when the auditor was right).

Secondly, there was a challenge as to what was going to be different. An incumbent introducing new ideas and innovations runs the risk of the challenge: why not before? (as noted in Phase 1 – four instances)

A related challenge identified in one interview was whether an incumbent auditor ought to change the team that was apparently doing a good job. A change would involve a loss of incumbent knowledge which might reduce their



inherent advantage but, at the same time, the new team might bring new ideas and innovation and therefore mitigate an inherent disadvantage.

The challenge for an incumbent auditor is perhaps best illustrated by a Group Financial Controller who said:

*“I work very, very closely with the audit team and there are people who assumed that [incumbent firm] would have an advantage in this process being incumbent auditor. You should do, business knowledge and that kind of thing you can play on, but actually I saw it as a disadvantage. ...because how do you make yourself new and refreshing...you’re almost on a hiding to nothing”*

The Phase 2a analysis suggests companies were more open to ideas, innovations and new approaches; without such a tight focus on past problems.

### **Audit transition**

As in Phase 1, concerns were identified in Phase 2a about the challenge of transition. Seven interviewees acknowledged the difficulties and challenges of transitioning an audit. They talked about the “hassle” of change and that changing auditors was not something that ought to be done lightly. A comment made by one financial controller exemplifies the issue:

*“You know changing auditors is no small thing in terms of the sort of knowledge that they will have built up over the years and obviously the smoothness of an audit. So ...on the basis of smoothness of the audit – would we ever change? Probably not”.*

Other changes taking place in the business were considered to increase the difficulty of changing auditors or indeed preclude it; there being an argument for too much change going on at any one time (four instances).

In one case the audit committee satisfied itself that there were two credible tenders; one was the incumbent, and the final decision was left to management as to whether they felt that they could manage the change effectively given the other challenges in the business.

As with Phase1 however, an inherent attraction was identified of new and refreshing ideas. The comparison became between new ideas and sticking with the current service. One interview suggested “the grass is always greener” and another suggested that change is good for its own sake and was in their case overdue.

The perceived challenges of an auditor change could also again be mitigated by transition planning by non-incumbent firms. There was evidence that companies recognised the investment that the non-incumbent firms had made to prepare properly for the transition (five instances). Examples included detailed transition plans and audit plans and more general investments of time that had been made to ensure that the audit firm was ready to take over the audit straightaway.

The proposing teams’ experience was also relevant. In one case, a major company drew comfort from the fact that the proposed team they selected was transitioning off another major company with similar issues such that they would not need to educate them. In another, the investment that the firm had

made in targeting and the past track record provided evidence that they had sufficient knowledge to take over the audit to meet a tight reporting deadline.

In total, 14 interviews discussed transition and the findings were similar to Phase 1; namely that transition could be a concern, but that some found change inherently attractive and, where there were concerns, these could be mitigated by activity before the tender and by sensible plans being submitted by the “challenger firms” as part of preparing for the future.

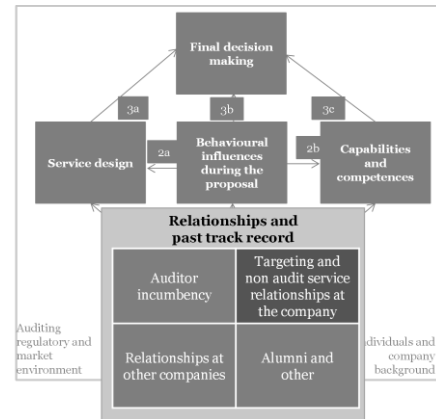
### **Incumbent’s overall position at the start of the proposal process**

In seven interviews respondents commented on whether they thought the incumbent stood any chance of retaining the work. One indicated that the tender was for corporate governance, one a merger and the others service related. Three interviewees (corporate governance, merger and one service) responded that the incumbent did stand a chance; the others thought it unlikely that they would be appointed. In the end all changed perhaps providing at least some indication that whilst a poor record most often led to a change, a positive track record does not necessarily lead to reappointment. In this environment, with such low retention rates, it was perhaps surprising that there was only one identified instance of an incumbent auditor declining to tender.

### **5.2.2. Targeting and non-audit service relationships with the company**

As noted in Chapter 1, the fact that many companies have non-audit relationships with other Big 4 firms arose at least in part from regulatory change

and the ensuing concerns over auditor independence. In Phase 2a there were 14 interviews which discussed the influence on the selection decision of targeting activity (as defined below) and of a past non-audit service track record with the company.



In total seven interviews referred to targeting activity (NB: In this context and consistent with Phase 1 of the current research, “targeting “ is used as commonly referred to in practice within the accounting profession as a “bundle” of activities aimed at building relationships and winning work at new clients through directed marketing activity and more specific business development meetings. It may entail elements of key account management or be less structured in nature but, in each case, entails a focussed investment in time with the company).

Particular targeting activities identified included technical accounting updates provided by a firm to company personnel, secondments of firm staff to the company before the tender process, introducing company management to relevant contacts both from within the firms (for example contacts in critical territories) and with other business contacts. In one case a number of briefing sessions had been organised by one of the firms for a new finance director concerning regulation and relevant industry matters. In two cases interviewees talked about the value of a development programme for future finance directors which one of the firms ran. In addition to being quite diverse these targeting

activities could also be long standing and, where sustained, could be highly influential.

One CFO commented:

*“I think the relationship and the effort put in definitely put [Firm x] in the lead what that’s worth who knows but certainly everything else being equal that would have been sufficient ... you’ve got to reward that sort of effort and attention”*

Five further interviews referred to past (fee paying) service relationships involving corporate and ex-patriate tax services, accounting advice and transaction support.

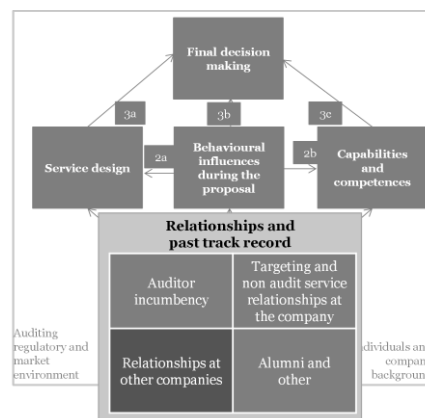
In terms of the influence on the selection decision the principal benefit of targeting and other non-audit service relationships for the companies seemed to relate to mutual knowledge. In two cases people talked about the importance of this and in two other cases of the negative impact when it was not there. One financial controller talked about building trust and one identified the importance of targeting as the level of commitment that had been demonstrated ahead of the proposal.

Although across the interviews the influence of non-audit service relationships was on balance positive there were also cases of a negative influence for the firms concerned. In two cases there had been fee disputes, in one case a local partner was known but disliked and in a third the issue was conflict where an existing non-audit service provided by one firm was valued

highly and this counted at least to some extent (although according to the company not decisively) against that firm being appointed as auditor given the independence concerns that it raised.

### 5.2.3. Relationships at other companies

The first two parts of this section were concerned with direct relationships between companies and audit firms before the audit tender; either as the incumbent auditor or by virtue of the fact that there were established non-audit services relationships or targeting activity.



Similar to Section 4.2.3 this section now looks at relationships and track record influences between those selecting auditors and the firms through past or current relationships *outside* the tendering company.

In Phase 2a evidence of the influence of past working relationships at other companies was substantial and this is considered first. There was very limited evidence of any influence of current cross-directorships. This is briefly touched on next.

#### **Past service relationships at another company**

Past experience of working with one of the competing firms could arise as a result of a change in employment of one or more of the key directors. The appearance of new management was identified as one of the potential forces for

change for an incumbent above, but clearly also affects the selection chances of any firm where it occurs. Such people bring either good or bad experiences of the firms from their previous employment.

The Phase 2a research identified 12 (52%) of the interviews where those on the selection panel had past experience of working with at least one of the competing firms at another company. There was then quite a high level of discussion although the nature and level of influence this appeared to have on the auditor selection decision was quite varied and, in some cases, complicated as the following paragraphs highlight.

Past relationships could have a decisive impact on the decision. Two cases were identified; one where the decision was influenced positively for the relevant firm, one negatively. In the first case the recent past experience of one of the firms was decisive because two of the directors had had a favourable impression of one firm and spoke up in favour of that firm in the final decision discussion. Their speaking for the firm involved was identified as decisive for their success in being appointed. In this case one of the directors had recent working experience with the individual who was the proposed lead partner.

The negative influence arose when one of the divisional directors had had a poor experience of working with a proposed partner on one of the teams and spoke up vehemently against the appointment of that firm. The firm was ultimately not appointed with this opinion having said to have carried weight.

In a further case there was a negative, but potentially not decisive, influence against one of the firms because the company CEO knew one of their

key people from a previous employment and wanted to be able to use that person for other non-audit services. Had they been appointed auditor this would not have been possible due to independence restrictions. So in this case, contrary to what might be expected following much of the relationship marketing literature, the firm was negatively influenced by a positive track record of non-audit service delivery.

How recent the experience was could also be important. Although company directors may have had established working relationships in the past, these could be overtaken by more recent targeting or work experience (three cases). In one of these cases, the Group Finance Director thought his previous relationship with one of the competing firms was very strong and he considered the partner leading their proposal to be a friend. However that firm was ultimately not selected. He felt his relationship had made the decision more difficult, but that was not enough to overcome the more recent targeting activity of the successful firm.

In other cases the influence of past relationships on the auditor selection decision was complicated by the fact that a number of those on the selection committee had relationships with a number of different firms. The Group Financial Controller of one company commented:

*“I knew one of the partners on [one team], the Audit Committee Chair knew most of one of the other teams because they audit the company where he is the Finance Director....[he also] knew [a third team] well [from past work]I*



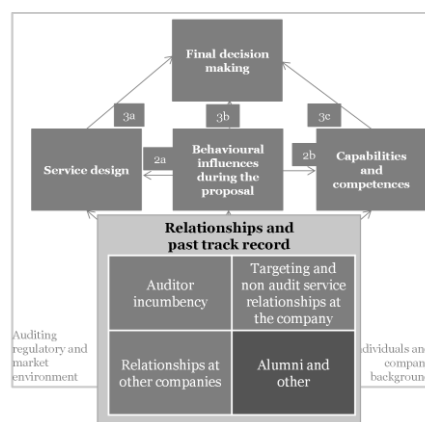
*don't think those relationships skewed the decision but I think if there had been a past issue with any of the firms it might have skewed it"*

### **Current cross directorships**

The high number of directors with more than one Board appointment in the FTSE 100 was identified in Chapter 1. There were multiple appointments in places, particularly involving non-executive directors. Because such directors populate the audit committees, who are formally responsible for audit appointment, an influence of such cross-directorships might have been expected. In Phase 2a however cross directorships were only mentioned in relation to two auditor selection decisions. In one case the reference was simply acknowledging that such relationships existed and, in the other, a comment was made about a recent tender at another company. There was therefore limited or no evidence of these cross directorships as an auditor selection influence in Phase 2a.

### **5.2.4. Alumni**

In Phase 2a there was noticeably more discussion about alumni relationships than in Phase1 and indeed eight of the interviews touched on it (over a third). In almost all cases, those interviewed were positive about their old firms at least to some extent although these relationships did not seem greatly to directly influence the results.



In one case an alumnus acknowledged that he had trained with the team from one of the firms tendering for the audit and indeed still socialised with them and considered the lead partner to be very good. However, although he had warned them that the tender was coming, he felt that during the process another firm had clearly put forward a better tender effort. It would not have been right or possible to overturn that. He commented:

*“So obviously in my position I’ve got to be impartial I think you embarrass yourself if you’re not these days and its obvious when if it’s a decision with a big group, it’s pretty obvious if you’re evidently favouring one for another”*

In two cases senior directors were alumni of competing firms in situations where those firms were incumbent. The recent negative service history at the company in these cases overturned any allegiance they may have felt to their old firm.

Similarly in another case many of the group finance team were recent alumni of one of the competing firms, but that firm was the subject of criticism based on past service problems elsewhere and was ultimately not appointed.

In one case the presence of a recent alumna was problematic for her old firm when that firm made assertions about what they were going to deliver in the audit. She knew they could not deliver what they were promising when she was employed by that firm and challenged them hard as to how they thought they could deliver it at the time of the tender.

In summary the findings in Phase 2a in relation to alumni were consistent with Phase 1 in that there are sensitivities and the interview evidence suggests that alumni relationships can be helpful (but not decisive) or unhelpful given the specific circumstances of the tender.

#### **5.2.5. Other relationship matters**

Phase 1 indicated that there was no evidence of personal or social relationships influencing auditor selection; instead relationship influences related to professional working relationships. Phase 2a findings were consistent with this. In only one case was a mention made that one finance director asked a Big 4 firm partner at his golf club to suggest who he should send the request for proposal to because he had no relationship with that firm. There is no suggestion that that partner was then involved in the proposal process.

Again references to loyalty were missing from the Phase 2a findings; and Phase 2a confirmed earlier the rather surprising indication (in the context of the professional services literature) of a low level of reference taking with only two of the 23 interviews touching on it.

There was however one notable difference from Phase 1 to Phase 2a and that related to trust. In Phase 1 it was noted that references to trust were absent from the interview records. In Phase 2a however there were references to it in five of the interviews, almost of a quarter of the total. It is not obvious why this may have occurred.

For two interviewees (one as identified in Section 5.2.2) it was important for trust to be established as part of the selection process. In one case trust was damaged when one of the lead partners tendering over-stated their experience claiming to lead an audit of a major company when they only in fact led the audit of one of its divisions. The Finance Director disliked what he considered to be overselling and subsequently mistrusted that individual.

In two cases the importance of trust in the audit service was also recognised. In both cases the importance of difficult issues being discussed in the right way and communicated to the audit committee appropriately was identified.

Lastly, one interview identified a need for inter-organisational trust with a need for trusting relationships to exist between the most senior people at the company and the audit firm; not just the audit team. In this case some major issues had been confronted in the period leading up to the tender between the company and its auditor.

This concludes the discussion of relationships and service track record influences on auditor selection. Important influences in relation to the company's relationship with its incumbent and with other firms have been identified. The next section considers the Phase 2a findings on the next higher order category, audit service design.

### 5.3. Service design

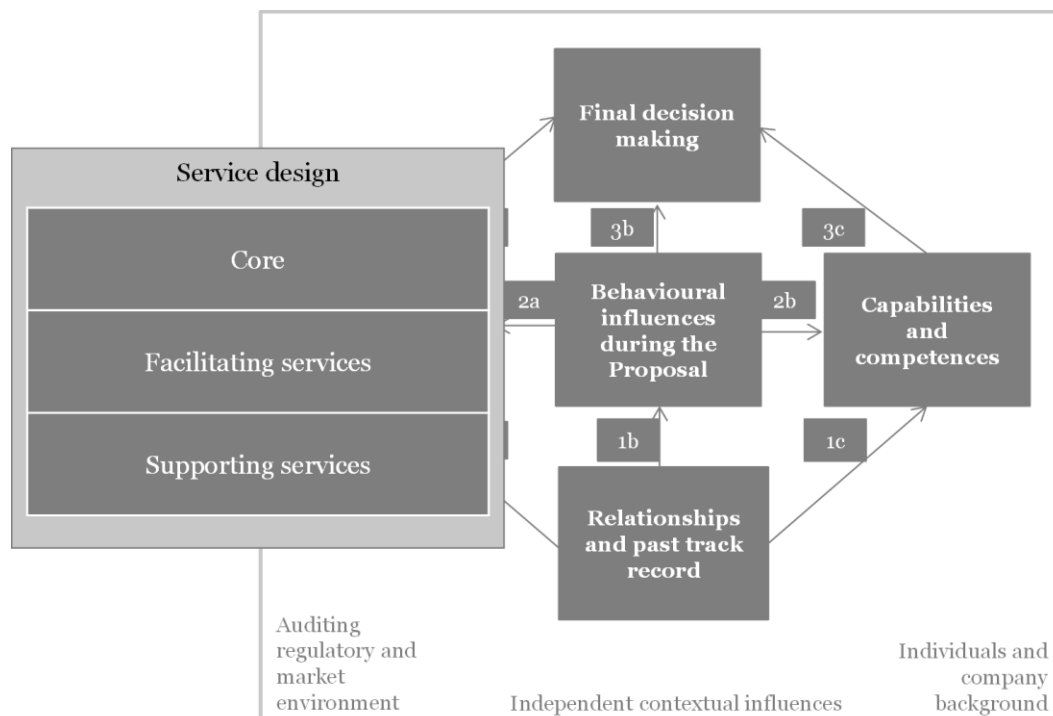


Figure 15: Service design influences on auditor selection

This section now sets out the Phase 2a findings using the same classification adapted from Gronroos (2007) as was used in Phase 1 to order the consideration of the auditor selection influences. These include the core audit, facilitating services and ideas and insights as a supporting service. The influence of fee on auditor selection is also considered.

By way of introduction this section starts with consideration of the evidence from the interview transcripts as to whether buyers of audit services thought that that service was a standard or a commoditised service or whether differentiation was possible. The latter would be consistent with service design being a decision influence in auditor selection.

### **5.3.1. Audit approach, general differentiation and tailoring**

The results of Phase 2a in relation to general differentiation and tailoring were consistent with Phase 1 with the balance of comment heavily towards the argument that the audit is *not* a commoditised service.

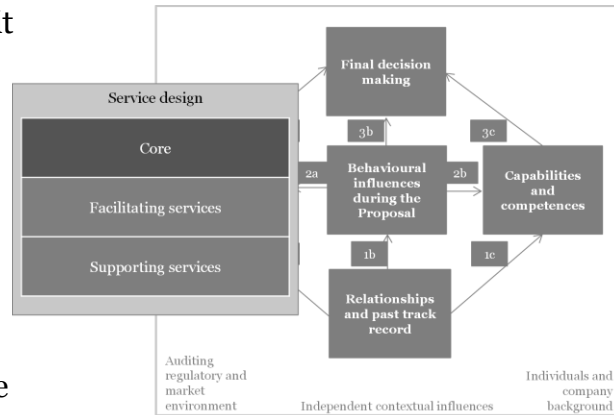
Although four interviewees commented that the core audit was “a given” (assumed to be available to an appropriate standard from all of the firms) and, in two cases, observations that the audit approaches that were proposed by the firms were not different, there were nine (39%) of the source interviews which highlighted tailoring of approaches and specific proposals. This was manifest in the final proposal documents submitted by the competing firms and in three cases by detailed audit plans submitted as part of the overall tender submission.

Audit service design was discussed in each of the 23 interviews and in addition to the general evidence of tailoring the areas of focus were largely the same as Phase 1. These were rigour and assurance from the audit (analogous with the core service and concerned with the technical quality of what was being selected), the facilitating services of coordination and communication, accounting technical matters, IT systems and controls and working with internal audit as facilitating services, and ideas and insights from the audit as a supporting service. In addition to these influences, Phase 2a also identified an additional area of influence relating to the audit service. This related to other aspects of the working relationship. This will be considered further in Section 5.3.3.

Each of the identified audit service assessment influences on auditor selection is now considered further starting with audit rigour and assurance.

### 5.3.2. Core audit –rigour and assurance

Phase 2a identified 10 (43%) of the interviews which discussed the needs for rigour and assurance in the audit service. This represented a substantially larger proportion of the total population than in Phase 1. A desire for challenge in the audit process was identified in three interviews, others talked of the need for a robust, rigorous, solid audit or just better assurance.



In addition to comments in relation to the need for overall rigour including challenge, there were also some insights into specific activities which companies thought would support rigour. These included, in one case each, confirming that the finance team had done what it should and the audit assessing the Finance Director and their team (a comment made by a Finance Director). In one case assurance in emerging territories was identified as particularly important reflecting the higher levels of operational risk which that company perceived to be present in those countries. Lastly, in one case, the influence of one of the firms employing data analysis tools to support the quality of the audit was seen as a positive.

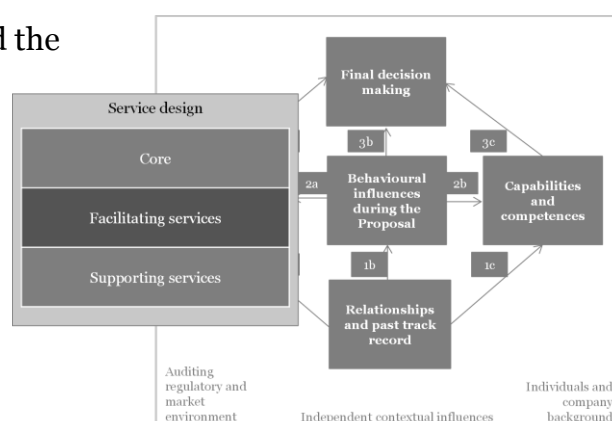
The need for rigour and assurance is illustrated by the comments of one finance director interviewed:

*“[Firm A] missed the point ....I’d asked them how to do my audit - I think we had an eight page document and on the middle page that was the first time they actually talked about their audit and how they’d do it.... And in the pitch they told me that anyone can do an audit which actually I saw as a real insult because actually I don’t care how anyone does it I want you to explain to me, in detail how you’ll do my audit because actually my head could roll if I get it wrong.”*

So rigour and assurance from the audit was again identified as an influence on auditor selection. The next section now looks at influences arising from the way the audit is delivered through consideration of facilitating services.

### 5.3.3. Facilitating services

The Phase 2a interview data identified five Facilitating services influences on auditor selection. These included the working relationship, accounting technical matters, coordination and communication, IT systems and controls and working with internal audit.



The numbers of interviews where each was discussed along with the references is set out in Table 19 below.



Factors	Sources	References
Working relationship	14	57
Accounting technical matters	11	46
Coordination and communication	10	21
IT systems and controls	7	15
Working with internal audit	5	9
Other	2	2

Table 19: Phase 2a sources and references for facilitating services

Four of these influences are consistent with Phase 1. Phase 2a identified additional influences related to how the service relationship would work. These have been grouped under a heading of working relationship which is considered first.

### **The working relationship**

There was considerable reference to the importance of the working relationship between auditors and companies being audited and 14 (61%) of the interviews included reference to this.

In three cases the interview identified the influence of the working relationship generally as important, in two of these especially so in difficult times and in one case especially for a smaller company. There were however also more specific references to aspects of the working relationship.

Notwithstanding the profile of the decision and the regulatory environment surrounding audit, companies were still valuing interpersonal aspects of the audit relationship in their decisions. People talked about the importance of identifying people they could work with (as an objective of the future audit service) (seven instances). For example a comment from a Group Financial Controller highlights the point:

*...part of it was a subliminal piece which was do you think you can work with these people... because that was key. Now for example our tax team were pretty clear that they couldn't, they really didn't think that they could work with [one firm's proposed] tax people.*

The need for sensitivity to, and fit with, the company's culture was also identified (four instances). Three interviewees referred to a desire to work in partnership, including mutual respect. This is of course closely associated with personal chemistry which is considered further under behavioural influences in Section 5.5

The interviews also identified that companies were looking for proactivity and valuing a straightforward approach, expecting auditors to be hands on and engaged and getting the basics right which were discussed in one interview each.

Lastly, three interviews identified the efficient completion of the audit as important including a precise timetable, getting the audit done with an efficient process that would make company executives' lives easier and not waste their time.

### **Accounting technical matters**

In Section 5.2 it was noted that whilst accounting technical matters had noticeably featured less strongly than in Phase 1, Phase 2a interviews still showed this to be a commonly identified area of concern for future service

design. In total 11 (48%) of the interviews identified aspects of accounting technical matters as areas for consideration in auditor selection.

The interviews did however identify a change in the balance and nature of matters being discussed in this area. Rather than problems such as engagement partner empowerment and accountability and responsibility within audit firms for dealing with accounting issues, in Phase 2a there was much more discussion about arriving at appropriate accounting outcomes; for example the company's desire to understand the available range of acceptable outcomes (four instances). In particular people were keen to understand how prudent the proposed outcomes were within the acceptable range and in one case specifically how all the accounting judgements that had been taken positioned the financial statements as a whole within this range. As previously mentioned this may relate to the later period covered by Phase 2 which is discussed in Chapter 7.

Companies also valued comments that the proposing firms made concerning the companies' annual reports and the various disclosures they included (four instances). In one case the fact that the annual report had been thoroughly benchmarked by one of the firms against the companies' peers was specifically identified as valuable to the company and therefore a positive influence in the discussion of auditor appointment.

Where companies were concerned about specific accounting issues they used the proposal process to further their thinking and/or ensure that the proposing firms were comfortable with them (two instances). In one further

case a company had recently resolved some complex accounting issues and wanted the proposing firms to understand and be comfortable with the outcomes that they had agreed with their incumbent auditor.

In two further cases the interviews identified that companies wanted the accounting decisions to be consistent with and support the overall business strategy.

The focus on the process of resolving accounting matters had not completely disappeared in Phase 2a, and three interviews still commented on the need to manage the input of technical accounting departments, and in one case, especially internationally, but the number of references to this issue was far lower than in Phase 1. As noted above, this is thought likely to be because of the later time period covered by Phase 2a. There were not so many changes in accounting rules within this time period as Phase 1 which had seen the introduction of new International Financial Reporting Standards.

### **Coordination and communication**

The importance of coordination and communication in what can be very extensive international audits was highlighted in Section 4.3.3. Within the Phase 2a interviews, the main areas of focus identified were around audit issue management, reporting and the style of communication.

The importance of audit issue management to auditor selection was identified in five interviews. Companies wanted to know that issues would be appropriately escalated from divisional audits, but also that unnecessary alerts

which were not really substantive audit issues were avoided. There was some concern that issues may be raised which, when discussed and thought through with the auditor, turned out not to be important. This is illustrated by a comment made by a finance director:

*“[The] initial view of an issue isn’t always where you land up on the issue when you’ve done the real thinking around the piece and therefore you need to be very confident that your auditor will address that in a sensible approach and get to the right answer without any sense of point scoring or trying to show they’re cleverer than you are”*

Related to the concern about dealing with issues sensibly, there was also concern to ensure that matters were reported authoritatively to the audit committees, but also that reporting was being done fairly and accurately (three instances – in every case the comment was made by a finance director). In two cases people were concerned about the quality of reports produced by auditors more generally.

The style of communication was also identified as important (three instances). In one case a focus was the openness of communication with auditors. In another it was important for the auditor to provide a sounding board for ideas and a third indicated a desire for communication to be straightforward.

### **IT systems and controls**

IT and systems and controls as an influence on auditor selection were identified in seven (30%) of the Phase 2a interviews. There was again a variation of approaches that companies were considering. For one highly information technology reliant company, the audit approach to their core operating system was at the centre of their selection decision (although ultimately it did not become a differentiating factor because each of the competing firms presented an approach which met the company's needs). For another company however, with operations in an emerging territory, there was nervousness about too much focus on IT systems and controls and a desire for more traditional checking back to records.

In two cases, companies valued a tailored approach involving experts on the effectiveness of the controls on their own specific IT environment (SAP or JD Edwards).

In addition, the use of audit technology by the firms themselves within their audits was also identified as an influence with one company identifying it as an important factor which differentiated the successful firm from the previous incumbent firm. The use of specialist software designed to interrogate a company's specific information technology platform as part of the audit was identified. Another company talked about the value of an online portal to share information internationally across the company as part of the audit.

The Phase 2 interviews therefore suggests that both the auditors' proposed approaches to relying on the companies' own IT and controls environment and

the use of its own technology in delivering the audit were capable of influencing the auditor selection decision.

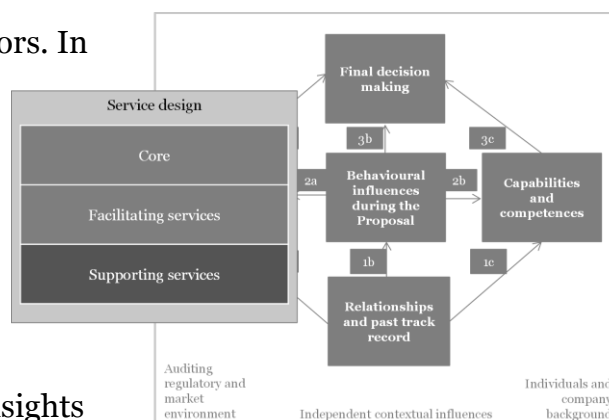
### **Working with internal audit**

Lastly in relation to facilitating services, the working relationship with internal audit was again identified as an influence for companies (five instances). Companies talked about their established internal audit functions and how they were keen for the external audit to be planned and coordinated appropriately to ensure that the two different teams worked most effectively together.

This concludes the consideration of facilitating services identified from the interviews with those involved in auditor selection. The next section considers the important supporting service identified and that is ideas and insights from the audit.

#### **5.3.4. Supporting services: ideas and insights from the audit**

There was evidence in Phase 1 of audit selection committees looking for ideas and insights from their auditors. In Phase 2a the focus on ideas and insights emerged strongly. In total 15 (over two thirds) of the interviews provided evidence of companies looking for ideas and insights from their audit.



It is important to note that this did not amount to a request to be able to buy additional services from their auditors. In one case the attempt to try to bundle additional services with the audit was received negatively as it included services that the company felt amounted to consulting and which therefore it would not source from its auditors due to its own strict independence policies governing non-audit services.

The nature of what companies were looking to receive may be illustrated by one group financial controller:

*“Yes you get an audit opinion which is what you know makes everyone happy and is required by statute but you’ve actually got quite a lot of talented people [auditors] spread all over the organisation looking at how you do things, could have the benefit of looking at your peers, looking at how other people do things”*

In six interviews people indicated that they were looking for ideas and innovation. In three cases reference was made to benchmarking an organisation against its peers.

In the context of receiving advice from their auditors (rather than buying consultancy services), the interviews identified a broad range of areas of interest to companies including support into new overseas territories (three interviews), tax, training company staff, advice with corporate social security matters (three interviews) and strategy, performance improvement, environmental issues and cost optimisation (once each).



The evidence suggests that companies have high expectations of the experience and talent that their prospective auditors could offer and were looking to receive the benefits of this as an integral part of their audit.

### **5.3.5. Commercial arrangements**

In Section 4.3.5, the background to fee setting in the FTSE 350 was explained and it was also identified from Phase 1 that fees were generally not influential to auditor selection decisions as had been identified in certain of the auditor selection literature. The reasons for this included the relative closeness of fee quotes provided by firms, the focus of selection committees on other criteria and the likelihood that fees could be negotiated after selecting a chosen firm.

In Phase 2a there were 14 interviews which identified consideration of fees as an influence on auditor selection. Among these 14 interviews, eight referred to negotiation, and this was the most discussed area under consideration of fees. In four cases, people confirmed that their preferred auditor was the most expensive and that a negotiation had taken place whilst in the other four, no negotiation had taken place because the preferred auditor had already submitted either a lower or comparable fee. A comment made by one Finance Director illustrates the point:

*“On the financials [Finance Director’s] attitude was that they needed to get the best firm and could negotiate. [Finance Director] said he had discussions with all of the firms. Before the discussions [successful firm] were out of line but that shouldn’t be the thing that drives it – much more about best*

*firm – needs to be right – best firm. If it couldn't be resolved only then would it become a show stopper”.*

Although two interviews identified companies looking for value for money with the context suggesting this meant lower fees, and in one case a fee reduction was explicitly identified as an objective of the proposal process, there was other evidence which showed concerns with such an approach. Three interviewees had concerns about whether a low fee was credible and in two others explicitly stated that they would be prepared to pay more for additional work. In addition one interviewee stated that the decision was never going to be about selecting the lowest fee, and in one further case it was even suggested that high fees were a convenient excuse to exclude a firm from consideration when in fact other factors were much more important.

Fees were assessed as comparable, and so therefore not a differentiator, in three cases and, in a further case, the relative small size of the fee as compared to the companies' other expenditures was also referred to.

Other influences identified included the desire for clarity over fees being quoted and certainty including fees fixed for more than one year.

The interviews in Phase 2a therefore provided evidence of a focus on audit fees, but for them not to be influential in many cases. This is because fees were already comparable, or that other concerns were felt more important or, most commonly, because there was, or companies believed there could be, negotiation to bring the fee quotes received from tendering firms into line.

Consideration of commercial arrangements completes this section on the Phase 2a interview findings as they relate to audit service design. The findings are consistent with Phase 1 and identify an assessment which includes audit rigour and assurance as a core attribute, facilitating services and supporting services within the overall selection deliberations. Fees were generally not found to be influential because they tended to be comparable, relatively small amounts and/or subject to negotiation which tended to be satisfactorily resolved in favour of the preferred firm based on other criteria. The next section now considers the influence of the capabilities and competences of the firms on auditor selection.

#### 5.4. Capabilities and competences

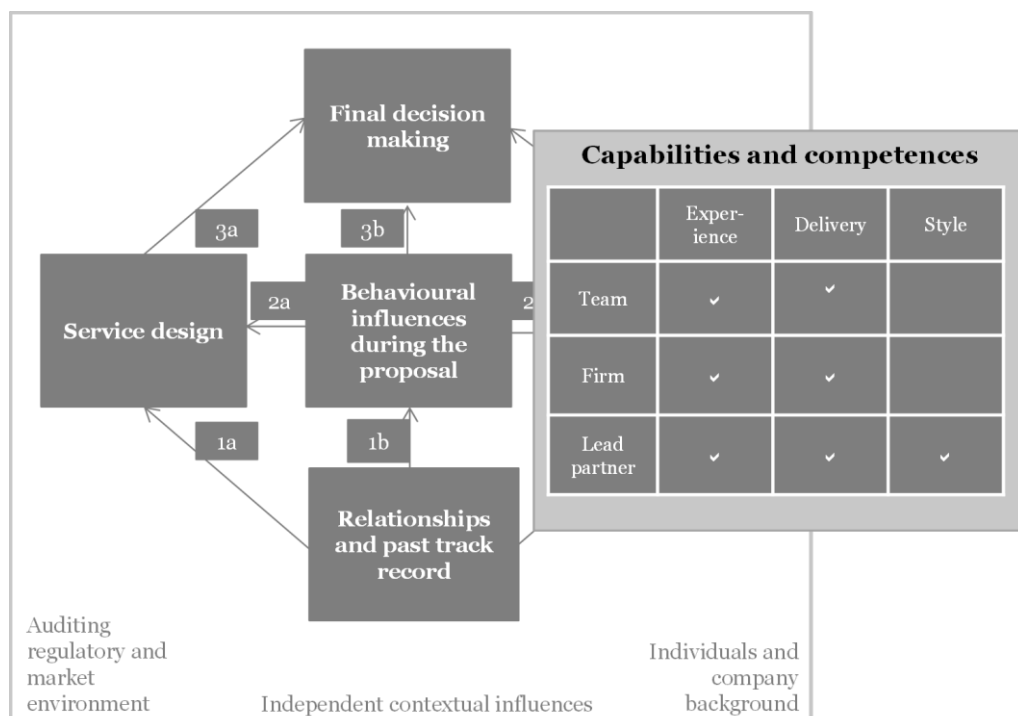


Figure 16: Phase 2a Capabilities and competences influences on auditor selection

Phase 1 identified competence and capability considerations operating at three levels within the auditor selection decision. These related to the firm, the team and the lead partner. The findings from Phase 2a supported these three levels of assessment.

The number of sources and references for each subcategory within the capabilities and competences higher order category are set out in Table 20:

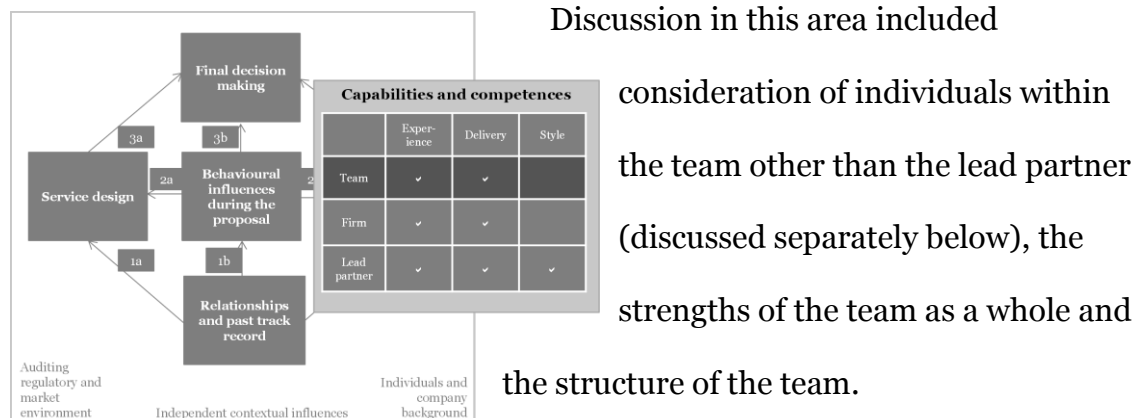
<b>Factors</b>	<b>Sources</b>	<b>References</b>
<b>The proposed team</b>	<b>21</b>	<b>164</b>
• Assessing individuals in the teams	17	64
• Strength of the team as a whole	14	69
• Structure of the team	11	26
• Other	3	5
<b>The audit firms</b>	<b>21</b>	<b>112</b>
• The Big 4 and the Mid-Tier	16	45
• Industry experience and expertise	13	29
• Conflicts with other services	10	18
• Geographic coverage	5	15
• FTSE company experience	5	5
<b>The lead partner</b>	<b>19</b>	<b>82</b>
• Ability to deliver the audit	15	35
• Style and connection	9	21
• Experience	7	15
• Lead partner rotation	7	11

Table 20: Phase 2a Capabilities and competences sources and references by factor

As the table demonstrates, the same three levels of assessment were identified. There were however some differences in the balance of discussion in the interviews both between and within these levels as the following sections now discuss further in descending order of the number of interviews which discussed them.

### 5.4.1. The team

This section discusses Phase 2a interview content as it relates to references concerning the proposing teams. This was the most referenced of the three levels and with 21 (91%) of the interviews covering it .



In relation to the team the influences identified included relevant experience in the relevant industry, geographical strength and depth and experience and expertise in the relevant segment (for example working with FTSE 100 companies). The section starts with consideration of individual team members. Given the high level of discussion specifically related to the lead partner this is dealt with separately in Section 5.4.3.

### Assessing individuals in the teams

#### Specialists

The Phase 2a analysis contained substantial references to specialists in the auditor selection process. Specialists were discussed explicitly in 12 of the interviews which was noticeably higher than in Phase 1. Whereas reference to specialists was present in some one quarter of the Phase 1 interview notes, for

Phase 2a this proportion was more than one half. The Phase 2a analysis identified evidence in particular of an important influence of specialists in risk management and accounting and internal control in particular, which were discussed in a quarter of all of the interviews.

It was also possible to identify a split between two types of specialists in this area; namely those that were an integral part of the audit team (such as those in risk management, information technology (including specialists in the particular software platforms being used by the companies), accounting and internal control and those who may be available as needed for specific pieces of advice, but not an integral part of the audit (referred to above in consideration of firms' Capabilities and competences). These were deep subject matter experts that companies might seek access to from time to time.

### **Group directors and senior managers**

A second group of individuals identified were the directors and senior managers working at the centre of the group audit.

The influence of audit directors and senior managers on the auditor selection decision was discussed in six interviews. Companies made general comments comparing those in one competing firm against another and also expressed interest in the likely continuity at this level and the understanding of business issues which individuals possessed. In one case a company was concerned that an individual had been a director for a number of years without progressing to partner, and questioned what that might indicate in terms of his ability. In another case the role of the director and senior manager were

identified as critical to the decision. For this organisation the competence of the partners was accepted as a given and they were keen to ensure the best working team.

### **Partners in overseas locations**

Partners in key overseas territories were also identified as an influence on auditor selection and also discussed in six of the interviews. Companies were interested in partners identified in territories where they had future plans as well as existing important areas of operations. There was some difference in the way that the firms structured their teams which companies commented on and reacted differently to.

Whilst, in a most cases, teams were constructed based on established relationships between the individual international partners on the competing team, in one case a company was impressed when one firm explicitly shied away from doing that and identified the team purely on their experience in the relevant industry sector.

In another case a positive influence on the selection decision of an experienced overseas partner in the relevant industry was noted even though the company's preferred relationship was for central control such that the finance director never expected to see the relevant individual if the audit was operated as he wanted it to be. He was still drawing assurance on the quality of the underlying work from his assessment of the individual that he met.

### **Junior members of the team**

In two interviews people talked about the importance of the more junior members of the team and, in three cases, stressed the importance of continuity of staff to avoid the need to keep educating new members of the team.

This section has talked about references made to individuals as part of the selection decision and identified the importance of specialists, the working partners and senior managers at group, partners in key overseas territories and continuity of more junior team members. Companies made comments about the strengths of the teams put forward as a whole and this is considered in the next section.

### **The team as a whole**

The interviews identified that companies were looking for a number of strengths in the experience and the expertise of the proposed teams as a whole (14 instances) and these are now outlined.

There were four main themes on the experience and expertise of the team namely industry experience, the quality of overseas teams, expertise of auditing similar FTSE 350 companies and more general comments about the proposing teams; each of these is now discussed.

Industry experience was highlighted in nine Phase 2a interviews having also been identified as the most often referenced attribute of the team in Phase 1. The importance of industry experience was raised in Phase 2 highlighting in particular the need for teams to be able to understand a business, to share good



practice from what others were doing, and as a way of creating value adding ideas. The importance of sharing industry insights was previously highlighted in Section 5.3.4 within Service design.

The presence of industry expertise in the team was considered essential, in many cases being identified as a reason to exclude firms in situations where it was lacking from a particular team. The comparative strength of industry experience and the quality of ideas that this generated was also a decisive factor in other situations. Therefore industry experience could be both a shortlisting factor and a final selection factor depending on the particular circumstances of the proposal.

A second area of influence as it relates to teams was the strength and depth of overseas teams (eight instances). There were examples of companies looking for strength and depth across a range of their operating territories. In some cases this took the form of a general assessment across relevant territories. For example:

*[Group Finance Director] also felt that consistency around the world and good quality everywhere was a factor – “being able to field good teams around the world”... “3<sup>rd</sup> places become show stoppers”.*

In other cases where there was a territory of special importance, more thorough and in depth assessments were seen to take place, including assessments of the firms’ local resources and obtaining feedback from other organisations locally. In one case a company went as far as interviewing the

proposed firms' more junior staff to assess their individual competence to undertake the audit.

The technical strength and credibility of the team was also identified as an influence on auditor selection. In five interviews this was identified explicitly and was expressed generally in the context of companies looking for a team with technical strength and also in terms of teams being able to deal with issues as they arose. In two cases, finance directors were expressly looking for teams who would be credible in front of their audit committees.

In addition to the specific attributes of the teams identified in the previous sections, in five of the interviews more general comments were made concerning the strength and quality of the of the teams competing in the tenders. These comments could be generally categorised under three areas.

Firstly, there were general comments on the companies' assessment of the quality of the competing teams as a group of individuals. Secondly, comments highlighted the general strength in depth of the teams, including in one case the negative influence on the auditor selection decision of a team having a strong leader but little strength below that leader. Thirdly, comments identified that certain auditor selection decisions were indeed taken based on assessment of the competing teams as opposed to any individual or the firm.

This section has talked about references made to the strength of teams as part of the selection decision. Companies also tended to talk about structure of the team and this is considered in the next section.

### **Team structure**

The principal issue from Phase 2a was that companies were looking for clarity in the way that the proposed audit teams were organised especially in relation to the most senior members of the team. Eleven interviews referred to issues related to the structure of the team.

Companies were keen to understand where responsibilities for certain elements of service delivery were being assigned and where decision making during the audit would be centred. There was also evidence of proposing firms finding this area difficult and putting forward proposals which companies looked upon, at least relatively, negatively. For example in one case a Finance Director did not understand how a team having both a relationship partner and working audit partner would work in practice. He felt that that got in the way of developing relationships through the proposal process. It was not clear who his prime contact was.

In another case, a firm proposed two partners but the company found a competitors' single partner proposal clearer and more attractive. In a third case a finance director understood that his prime contact was an audit partner but was then frustrated when a more senior relationship partner led all the meetings and the presentation.

Clarity of responsibility within the central team more generally was also a problem in one case, where a firm put forward a team containing a number of partners, directors and senior managers. The company was concerned about a lack of clarity about who was responsible for what.

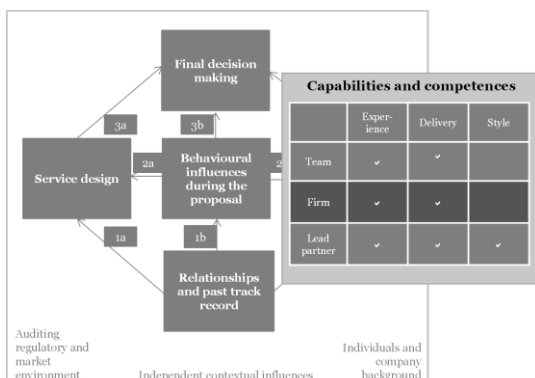
In a further case, the Audit Committee Chair did not understand the role of a director because that position had not existed when he had worked in the auditing profession in the past.

Lastly for one company (and there was a similar case in Phase 1) the global structure of the team was important. This related to whether firms took a centralised approach or put forward partners to coordinate key territories or global regions.

Overall then the structure of the team was seen as an influence on decision making and one which could be important, especially as firms seemed on occasion to struggle to get their proposals in this area to clearly meet the companies' needs.

Consideration of the influence of team structure completes this section on the influence of the team which has considered the individuals, the team as a whole and the team structure. The next section now considers the second most referenced level of assessment within Capabilities and competences and that is that of the audit firms.

### 5.4.2. The audit firms



The influence of comparison of firms related to capability and competences assessment was discussed in 21 (91%) of the interviews in Phase 2a.

The principal topics of discussion were comments on the Big 4 and comparison with the next biggest or Mid-Tier, industry experience and expertise, conflicts with other services, geographic coverage and relevant experience at similar FTSE 350 companies experience. Each is now considered in turn.

### **The Big 4 and the Mid-Tier**

The dominance of the Big 4 in audit tenders was discussed in Chapter 1 and supported in Phase 1. Phase 2a also identified that whilst companies appeared to see little difference between the capabilities and competences of the Big 4 in general terms they did see such a difference between the Big 4 and the next tier of audit firms.

In the 11 interviews that included comparatives of the Big 4, the overall theme was one of companies *not* feeling that they could be differentiated. In five interviews companies stated that any of the Big 4 involved in the tender could do the job adequately or well. In addition three others felt that all of the Big 4 were good or very good and one noted that, whilst all had made claims of leadership, they had been disregarded. In total therefore nine (39%) of the interviews explicitly identified companies not considering the Big 4 to be differentiated. In one case a company official felt that movement of people between the Big 4 was one reason why they were not generally differentiated.

In four interviews the issue of branding was discussed and although one company official felt that one firm was the premier and another identified that each may have its own house style, it was more common for companies to

conclude that there was no difference in brand or that the Big 4 itself was a brand.

By contrast, the eight interviews which included comparisons of the Big 4 with the Mid-Tier did support that companies felt there was a difference. In six cases the issue was reputational with one Audit Committee Chair explicitly stating:

*“..you never get fired for choosing IBM and you’re never [going to] get fired for choosing one of the Big 4”*

In four cases companies were concerned about the lack of breadth offered by those Mid-Tier firms; in one case about their lack of experience in the FTSE 350. In a further case concern was expressed about the calibre of the staff employed by the Mid-Tier firms as compared to the Big 4.

It is also worth noting that in a number of tenders covered by Phase 2a there was no Mid-Tier involvement and companies may not in these cases have covered this topic as an important part of their final decision (as compared to their shortlisting process).

The findings from Phase 2a are therefore consistent both with Phase 1 and the findings of the various regulatory and competition reviews discussed in Chapter 1. Consistent with Phase 1 there appeared to be no *general* differentiation of the Big 4.

As in Phase 1 however, there were factors which enabled companies to differentiate between the Big 4 in the context of their own circumstances and

the main themes were also consistent. The findings of Phase 2a which relate to this differentiation, and therefore influence the auditor selection decision, are now therefore discussed, starting with industry expertise.

### **Industry expertise of the firms**

In Phase 2a evidence of the influence of firms' industry experience was present again (13 instances) as both a shortlisting factor and a positive influence on the decision. There were three main topics of discussion.

Firstly, whether the Big 4 could be differentiated in the context of the particular proposal and in the particular industry. Four interviewees thought that this was the case. As might be expected, these related to more highly specialised industries.

Secondly, industry expertise arose (four instances) where companies had concerns over whether one or more firms actually had the relevant expertise. In one case the firm had relevant expertise in the industry concerned, but not audit experience in that industry. The company was therefore concerned that although one of the Big 4 had specialists in its industry, they were not auditors so had no direct relevance to the auditor selection decision.

Thirdly, industry expertise was considered important (four instances) because, as noted above, companies were looking for ideas and insights from their industry. It is perhaps interesting that much of the literature about industry specific auditors has focussed on this being a proxy for audit quality.

These findings suggest that there is more to it than that and that knowledge sharing is also important.

The challenge of offering industry knowledge, but not working with competitors, was also again identified. In four interviews this issue was discussed. At its extreme an audit proposal was triggered by a company's existing Big 4 auditor agreeing to tender for the audit of a company's competitor. In this case there was also a change in auditor (even though the firm affected was unsuccessful in the tender for the rival). In one other case a Financial Controller indicated that the company concerned would not choose to select a firm which audited its closest rivals. However in another case a Finance Director had said they had consider a potential conflict involving one of the firms and their audit of a major competitor, but had concluded that it was manageable. Lastly, a potential conflict with an audit by one of the firms of a competitor was resolved when that firm put forward a team with no involvement with that audit after changing a key individual.

Companies were seen to be testing industry experience (as will be returned to in Section 5.4). For example in one case a Big 4 firm had established itself as the industry leader in the eyes of one company, based apparently on the marketing activity of that firm, and this was decisive for them to be shortlisted. Ultimately however that firm was not successful as the company's view on the relative strengths of the firms was changed by evidence presented by another firm during the process. This second firm was assessed to be as experienced in the industry and therefore the final decision was more influenced by other factors. Another company concluded that a particular firm which it had



considered strong in its industry actually had limited relevant audit experience and this became a concern in the selection process.

Lastly, in one case, an Audit Committee Chair talked about appointing an auditor with industry experience as the company would not be criticised should something go wrong. In this case the relevant company was in a specialised industry with important industry specific challenges in its accounting and reporting.

### **Perceived conflicts of interest with non- audit services**

The background to auditor independence and perceived conflicts with auditing and other non-audit services was discussed in Chapter 1 and in Chapter 5, three sources of conflict in this area were identified:

- Conflicts with other services that were currently being provided by a prospective auditor;
- Non-audit services that had been provided in the recent past (giving rise to a self-review risk as explained in Chapter 1); and
- Conflicts which arose as a result of the relationships that company board members had with the competing firms (in Chapter 4 the issue that a director of the company was employed as an advisor to one of the Big 4 firms).

In Phase 2a conflicts with other services were identified as a selection decision influence in ten ( 43%) of the interviews and although there was no

incidence of complications created by individual board member relationships in this phase, the other two influences were again present.

Where there were perceived conflicts with other services, the relevant firm had been excluded from the process (four instances). For example, in two cases, one of the Big 4 firms was excluded from the audit proposal process because they were the company's preferred tax advisers. In one further case recent tax advice although completed was arranged with fees which were contingent on the future savings made. Because these contingent arrangements had not been concluded prior to the proposal the relevant firm which provided the advice was excluded from the process (they would have been auditing the numbers upon which their contingent fees were based). In some cases conflicts arose because the situation brought into play regulatory restrictions; in others they were driven by the companies own policies and/or preferences.

Where firms were included in the tender process, companies were still mindful of conflicts. One finance director was concerned to ensure that including a Big 4 firm that was the company's internal auditor would not cause any independence problems. A Chief Executive was noted as having a preference for using another Big 4 firm for non-audit-services.

More generally in one case, an Audit Committee Chair identified that, having no conflicts with other services, was one of the general selection objectives. Indeed a financial controller suggested that given all the focus on auditor independence and the opportunities for non-audit work it may be better

for firms *not* to be the company's auditor. Another Audit Committee Chair commented:

*"You know the irony of all this is that nowadays you almost have a better chance of getting more work if you're not the auditor so I guess your dilemma is you know the flags you want to wave in reception as it were of FTSE 350 audit clients versus the amount of fees you actually want to take in and they won't necessarily lead you to the same place"*

### **Local strength in depth in key UK and overseas locations**

There were five interviews which discussed a company's need for the right depth of resources in the right places. Most companies when they commented on regional and global strength in depth, felt that all of the Big 4 had adequate coverage to complete their audit. This also extended to many new operating territories including China. There were however exceptions.

Consistent with Phase 1, there was one case of a regionally headquartered company in the UK expressing concern about the ability of the local offices of the Big 4 to service them locally and, specifically, about whether they would have the right calibre of staff. This concern was based on some issues that they had experienced with their incumbent auditor in the past.

For another company, the assessed weakness of one of the Big 4 in a critical emerging territory in which it operated was identified as important and a limitation without which that firm could perhaps have won the tender. It appears that at least in some cases companies have needed to assure themselves

that even the Big 4 had the necessary resources to provide competent teams everywhere and in at least one case this proved impossible:

*Group Financial Controller: These other guys had to prove that they could do and one of them quite frankly, lovely, lovely firm, lovely people, we just weren't 100% sure they've really got what it took for [major emerging territory] and that's the biggest part of our business.*

A third company discussed how their assessment of the Big 4 in a critical emerging territory for them had also taken into account the other clients of the Big 4 in that territory. A concern was expressed about whether a firm could have adequate resources to audit them in that key territory when they also audited a major competitor.

### **Experience in the FTSE 350**

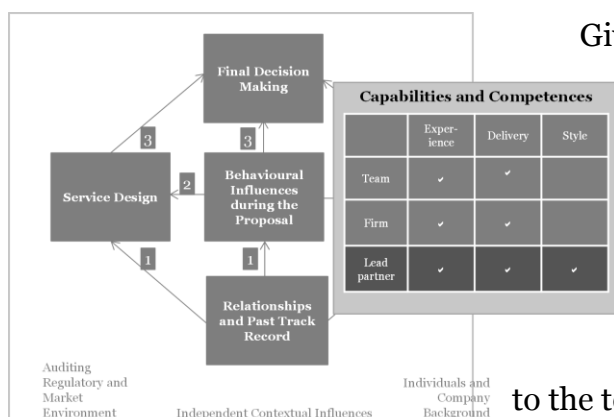
Lastly, in relation to firms' Capabilities and competences, and in addition to the comparative comments which firms made about the Big 4 and the Mid-tier referred to above, in five interviews companies also talked more generally about the listed company experience of the firms.

The influence of specialists within the audit team was discussed in 5.4.1. Five companies also talked about access to specialists not directly involved in the audit. These were typically professionals with experience of issues facing other larger companies including cost reduction, contract assurance, capital raising, structuring or transaction support and specialist areas of legislation, for example the Bribery Act.

Access to specialist capability, as well as assessment of specific competence, was therefore seen as a positive. However the broad relationships and skills bases that this can entail were also identified as potentially problematic in auditor selection as companies identified perceived conflicts of interest as referred to above.

In summary in relation to the firms, in selecting their auditors, Phase 2 suggests that companies face some important challenges. Industry experience and expertise appears important, but in many cases this is gained by working with their competitors which causes concerns over resourcing (and more generally). Similarly, companies are seeking specialist input in non-audit services but concerns over regulation and independence mean that using other firms reduces their realistic options as to who could become their auditor.

### 5.4.3. The lead partner



Given that the interviews identified a

high level of discussion of the individual lead partner the relevant matters identified have been split out from these relating to the team and are considered here.

Overall 19 (83%) of the 23 Phase 2a interviews explicitly discussed the lead partner (NB in other cases interviewees tended to speak in more general terms making comparative statements about the competing teams or firms). One Group Financial Controller in particular commented:

*“The Audit Committee all know [the firms] can do the job, it’s a question of looking across the table and knowing the person in the room can do the job”.*

Phase 2a supported the presence of the three previously identified influences of perceived ability to deliver the audit (15 instances), partner’s style (9 instances) and experience (7 instances). There was therefore a different balance from Phase 1 where the lead partner’s style was discussed slightly more often than their experience and perceived ability to deliver the audit.

Examples of how this ability to deliver an audit was manifest included the need for the lead partner to be in control of accounting judgements. One Group Financial Controller observed:

*“You know that appealed to us .... the lead partner going [sic] I’m in charge, other partners in other countries have got opinions which they send to me, I read them but if I don’t agree .... I’ve got the power to override something in light of the bigger picture or the Group opinion”*

Another specific example was companies’ assessment of how well the lead partner would deliver the resources of the firm when they were required.

Another Group Financial Controller highlighted for example:

*Group Financial Controller: “What I found impressive about [Lead Partner]’s approach to this and about him as a partner is that it was evident to me very early on that he could marshal the quality of resources that he would be happy with giving to the client and that he wouldn’t be under resourced and he would only have quality people but he had the contacts within [his firm] to*

*deliver so you, you know you're not dealing with a fool you've got somebody who can bring the right people to the table".*

As with Phase 1, reference was made to the importance of the lead partner's style and personality. Some of this appeared to be further associated with their ability to be effective in delivering the audit by having the right relationships with senior company officials. The following example illustrates a need for the lead partner to be respected:

*Group Finance Director: "The guy from [x firm] had the gravitas that said my Chairman and my Chief Exec will listen"*

There were less references in Phase 2a to the lead partner's experience and in particular experience in the relevant industry although, as noted in Section 5.4.2., there were more references to the industry strength of the team in this phase of the research than in Phase 1.

The importance of the lead partner was also evidenced by the impact of their mandatory rotation discussed previously in chapters 1 and 4. Rotation of the lead partner was discussed in seven of the interviews. In most cases this arose in the context of why the decision had been made to conduct an audit tender; where a lead partner was rotating off the audit it triggered an audit tender. In one case the rotation back on of a previous audit partner was seen as a positive as he brought knowledge of the company from his previous incumbency.

Having to change the partner was however not always a negative influence. In one case a change in partner and the fresh approach that a new partner introduced was highlighted as an important reason for the incumbent auditor to retain the audit. In that case the inherent challenge to incumbent auditors of companies looking for fresh ideas as considered in Section 5.2.1 was met by the change in partner rather than by a change in firm in that case.

In summary therefore, there was substantial evidence of lead partner assessment being an important part of the auditor selection decision with consideration of their experience and in particular their perceived ability to deliver the audit being foremost as well as their rotation coinciding with audit tendering.

This concludes the discussion of the findings from Phase 2a as they related to the influence of capabilities and competences on the auditor selection at the individual, team and firm levels. There is also evidence of influences of experience, perception and clarity about delivery and of style; the latter especially connected to the lead partner.

The next section now considers the next identified factor group namely Behavioural influences during the proposal process.

### **5.5. Behavioural influences during the proposal process**

Phase 2a provided substantial evidence of behavioural influences on auditor selection. These behavioural influences were identified in each of the 23 interviews.



As part of Phase 2a axial coding, seven subcategories of behavioural influence on auditor selection were identified. These were similar to Phase 1 and included the general assessment of the quality of response of firms in complying with the tender and six other behavioural influences. For Phase 2a however,

upon further reflection it was considered that these seven could sensibly be reduced to four subcategories reflecting the nature of what was felt to be going on in the behavioural

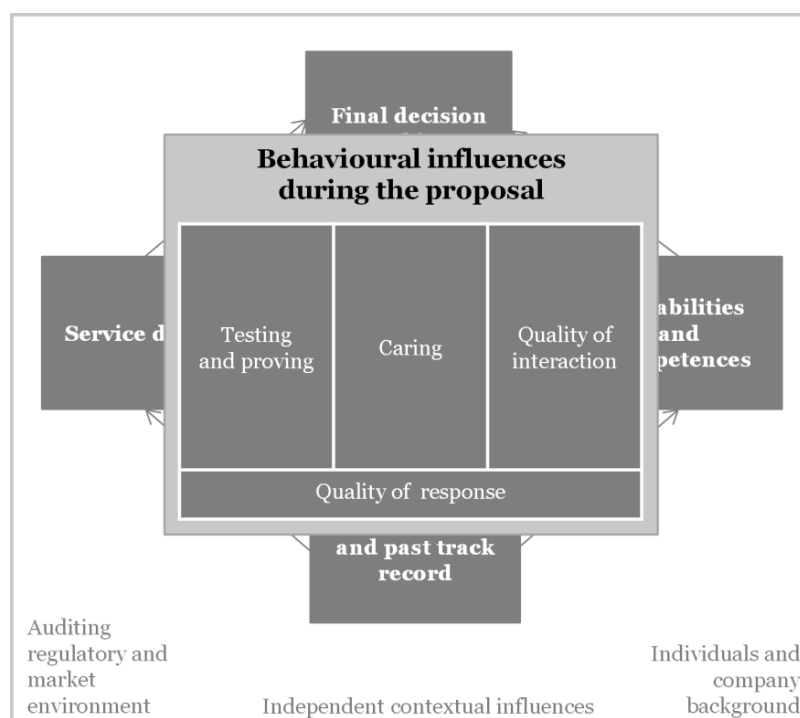


Figure 17: Behavioural influences on auditor selection

interactions taking place. For example for two subcategories, “Assessing competence and capability” and “Testing ideas and proving propositions”, the underlying behaviour seems to be that the companies and the firms are testing each other and seeking proof to support what was being said. Whilst the companies are testing the teams, at the same time the teams are testing their ideas and seeking to prove their propositions.

Similarly a new subcategory, “Caring”, brings together the comments made by the companies about proposing firms demonstrating behaviours such as hunger, energy and commitment, with those related to listening and

understanding. By demonstrating interest and enthusiasm the audit firm was really highlighting that it cared about what was going on and what was needed and wanted.

Lastly, the general nature of the interaction between the companies and the proposing teams has been grouped with that between the teams themselves. This reflects the fact that the overall dynamic of interaction included that within teams as well as between teams and the companies.

The four new subcategories, consolidating the seven initially identified, are set out in Table 21 along with the number of sources and references for each.

<b>Subcategory</b>	<b>Sources</b>	<b>References</b>
<b>Testing and proving</b>	<b>22</b>	<b>120</b>
• Testing and assessing competence and capability	20	72
• Testing ideas and proving propositions	18	70
<b>Caring</b>	<b>21</b>	<b>97</b>
• Hunger, energy and commitment	19	60
• Listening and understanding	14	37
<b>Quality of interaction</b>	<b>20</b>	<b>92</b>
• Engagement and connection	19	73
• Teamwork	11	19
<b>The quality of response</b>	<b>20</b>	<b>84</b>

Table 21: Phase 2a sources and references for Behavioural influences

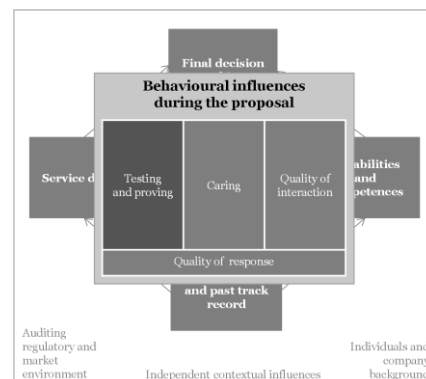
It is very noticeable that discussion of behaviour covered a range of interaction and only a small part of it related to the quality of the specific response to the requirements set out in the invitation to tender.

Phase 2a identified that five out of the original seven factors were each discussed in over 75% of the interviews. There was also a much greater number of references; underlining the presence and importance of the behavioural influences on auditor selection.

Each of the four factors identified in Table 21 is now considered in turn, organised in descending order of the number of interviews and references identified. Consideration therefore starts with Testing and proving.

### 5.5.1. Testing and proving

Phase 2a suggested that an important element of the behaviour that was going on between companies and the firms proposing for their audits was mutual testing. For the companies they were testing the teams including their competences and the quality of their ideas. For the firms, they were testing their ideas about the future service and relationship.



### Companies assessing teams and their propositions

There were 20 interviews (87%) which highlighted comments that companies made about the performance of teams and their responses to questions and challenges.

These comments, in the context of extensive proposal processes, were perhaps somewhat surprisingly skewed towards the final presentation. In nine interviews there were general comments about individual and team performance in the final presentations. In three cases there was a focus on new people who had not been met during the proposal process. In one further case there was a heavy focus only on the lead partner (with others being discounted)

however in a further case the emphasis was on the performance of the more junior members of the team. In this latter case the competence of the more senior people was assumed.

Seven interviews talked about the weaknesses demonstrated by the firms in their final presentations. These related to the general style of the presentations, for example “*flat*” or “*superficial*”, to elements of the presentations for example where people were deemed to be rambling in places and to specific errors that put their proposals in jeopardy; “*shot themselves in the foot*”.

Nine interviews talked about the questions they asked during presentations. In some cases these were standard lists posed to all the firms, in others, completely tailored depending on specific issues identified in each individual proposal document or meetings and in some cases a mix. In one case thoughtful answers were specifically seen as positive. One interview highlighted a company specifically looking for weaknesses in the firm’s people or arguments.

It was a recurrent feature of the discussions which took place that much of the focus seemed to be around general performance of teams and individuals in presentations. The way that teams performed in the presentation seeming to be at least as much about how they came across as about the substantial content of what was said. In an extreme example one audit committee chair commented:

*“It’s always difficult to distinguish what’s glitz with what’s not but if they can put on glitz that’s encouraging.....you’re confident with the major firms they’re up to scratch” [from a substantive perspective]*

In comparison to the final presentations, other comments in relation to performance of the competing firms were relatively sparse although three interviews commented more generally on the way that people had been perceived to be of high quality, based on the language that they used and the knowledge they imparted.

Lastly (as noted above) where all of the firms were making claims to leadership in relation to a particular aspect of their market position, these claims were disregarded for everyone (two instances). In one case where individual experience had been exaggerated, this had a negative impact and caused other claims made by that person to be treated with some scepticism.

### **Firms testing ideas and proving propositions**

Whilst the selectors of auditors were seen to be testing the competing firms and their arguments, the firms were testing their ideas with the tendering companies and seeking to bring their ideas to life. This was present in 18 (78%) of the interviews.

In six interviews, firms were identified testing new ideas. These related to suggestions as to how to change the existing approach so as to add more value to the audit, for example by helping to contribute more constructively to resolving issues, working more effectively with internal audit or providing bespoke

training. In three other cases the incumbent was seen to be testing changes to their service proposition in response to feedback that had been received.

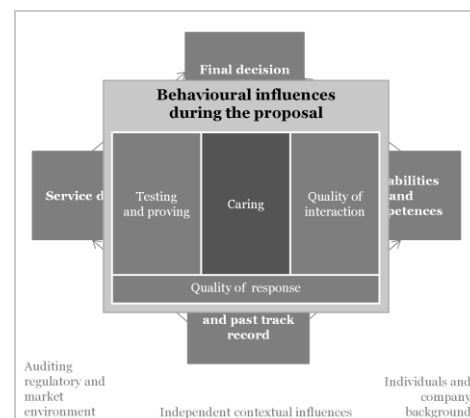
Firms were also testing and changing their teams through the process (four instances). In one case a number of partners were put forward for consideration before the tender and in another the lead partner was changed during the tender as a result of feedback received. The checking of the team included independent checking by a senior partner outside the proposed audit team.

In three cases the firms were identified testing their propositions in the final presentations. In four cases people talked about the firms using examples to help to explain their propositions and another used analogy.

The notion of putting forward propositions and testing them is of course consistent with the ideas of co-creation of value discussed in relation to value in use and Service Dominant Logic in Chapter 2.

### 5.5.2. Caring

The second of the behavioural influences from Phase 2a combines the comments made about proposing firms demonstrating such behaviour as hunger, energy and commitment (i.e. behaviours that signalled the proposing teams and their firms really wanted the audit) with



those which were made about the influence of the firms and their teams showing that they were listening and understanding (i.e. that they were taking time and giving attention to identifying what companies were really looking for).

### **Hunger, energy, enthusiasm and commitment**

The importance of the proposing firms demonstrating behaviours which signalled they really wanted to win the audit was identified in 19 (83%) of the interviews. These behaviours were categorised as hunger, energy, enthusiasm and commitment.

This influence is perhaps best encapsulated by a comment made by one finance director:

*“You want someone who wants the job – passion for doing it – you want people who want to work for you”*

The demonstration of enthusiasm by the firms was considered important. Interviewees commented positively on enthusiasm (five instances) and in the related areas of firms demonstrating that they wanted the work (three instances) and/or were hungry for the work (three instances).

For three interviewees the relative importance of their company to the proposing firms was the factor that mattered. For them their company needed to be a priority or crown jewel client for the proposing firms.

The interviews also provided evidence of the activities that created an impression of hunger, energy, enthusiasm and commitment. In essence there appeared to be three types of influence.

Firstly, an impression of hunger, energy and enthusiasm was created by firms going beyond the requirements of the invitation to tender. In eight cases this related to firms investing in the style and production quality of their documents (as opposed to the written content). In seven cases the firms' investment in producing bespoke video material was also noted. One finance director commented:

*"The video piece was important. It signals investment. A neat thing. [It] signalled you were serious about this. What it says is here are guys who are serious about the gig".*

Firms also created internet microsites to share information and support their ideas.

Secondly, in three cases comment was made about firms investing time in meetings and pushing for more time. Although, in one case, a firm was also viewed less positively for appearing to be desperate. In a further case a company was negatively influenced because they felt a particular firm had tried to set up numerous meetings without really demonstrating that they had thought about what was important and so the meetings lacked focus.

Lastly, two interviews identified that the timing of activity was influential. In one case being "quick off the mark" was a positive and in another being "slow out of the blocks" was a negative.



### **Listening and understanding**

The importance of listening and demonstrating understanding was identified in 14 (61%) of the interviews.

Comments in relation to listening were present in 11 interviews and they could be summarised rather simply as the positive impact of listening and the negative impact of not listening. Firms were seen to be listening or to have listened through the way that they behaved during the proposal process, the responses they gave to questions in meetings and presentations and by the propositions they put forward in their documents. This latter point being demonstrated either because particular areas of interest were addressed properly or because of the detail with which firms responded.

Importantly, it was not just the act of listening that mattered; it had to be associated with a response. This point may be illustrated for example by a comment made by a Finance Director:

*The feedback I got, especially about [partner A] was very positive because he's very good at...he's a good listener ... he often follows up points that are raised at the meetings which impresses anyone... I think genuinely none of them felt they were being sold anything"*

This may be contrasted with the comments made by a financial controller in relation to the way some firms approached the final presentation:

*“You know it’s just like you have not been listening ...in sales mode...I just think some of them need coaching in that. Would it have changed our decision ultimately? No but it might have made it a lot harder”*

Firms being seen not to have listened resulted from their behaviour in the final presentation and in the way that they approached the overall proposal process.

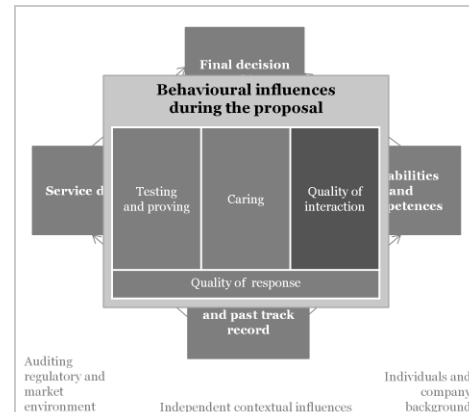
The related area of the importance of demonstrating understanding was identified in eleven interviews. In five cases people identified the importance of firms demonstrating understanding of their business generally and in one further case the importance of understanding the market context. This links to the desire for industry knowledge identified as a selection influence under Capabilities and competences assessment considered in Section 5.4.

There were also examples of companies looking for understanding more broadly of the company and its people and what they wanted. One Finance Director described this as firms demonstrating understanding of *“what our world is like”*. Another Finance Director thought it was about whether people showed more generally that they had understood the company’s needs. In two cases people identified that understanding their culture was important.

### **5.5.3. Quality of interaction**

The third subcategory of behaviour identified from Phase 2a related to the influence on the selection decision of the general interaction that took place during the proposal process.

The evidence suggests that interaction between the companies and the proposing firms is highly influential. This is described below as “Engagement and connection”. Phase 2a also supports that companies are observing and taking note of the way that teams are interacting with each other and the teamwork that is being displayed. Each of these two influences is now considered further.



### **Engagement and connection**

Engagement and connection related to the positive influence on the auditor selection decision of those involved connecting interpersonally by establishing personal chemistry and discussing the right topics of most interest to companies.

In total, 16 of the interviews (70%) talked about matters related to personal chemistry and whether people liked key members of the tendering firms. There were comparisons being made about how much people liked members of one team versus another (four cases) and of people talking about people they liked (two cases). For example:

*Group Financial Controller: “all four can do the job, its about personality...did we like [the lead partner from Firm x] ? Yeah... do we like other people better? Yeah”*

In three further interviews, people spoke specifically about the need to establish personal chemistry. Further interview discussion highlighted the importance of building a relationship during the proposal process (three instances); in one case referring to bonding through the proposal process, in another referring to establishing a personal connection. Lastly in one case a firm was discounted from selection because of what was described as a personality clash.

The Phase 2a interviews also provided evidence of more specific behaviours which appear to support or detract from the establishment of personal chemistry.

Supporting the development of personal chemistry were factors such as the style of interaction matching the culture of the organisation, meetings engagement and showing empathy. Two further interviews discussed the impact of social contact during the proposal process. In one case a financial controller thought it powerful that the proposal document shared details of the team's personal background and interests. Others talked about the general quality of engagement with the non-executives in the final presentation (three instances).

Those behaviours which were seen to damage interactions included arrogance in the final presentation (three instances), presenting in a style that did not fit with the audience at the final presentation, and in one case, people being offended by a firm trying to tell them where to sit.

So how people interacted at an interpersonal level was identified as an important influence on auditor selection. Engagement and connection was

however not only about how interaction occurred, but also the matters that that interaction revolved around.

There were nine interviews which talked about the positive impact of an appropriate agenda or, more often, the negative impact of not focussing on the right topics. Commonality of issues between the company and the tendering firm was important (two instances) and in a further case simply that meetings were more interesting where a firm had created the right agenda. Conversely firms were criticised where they lacked focus on the right issues or territories, spent too much time talking about themselves and their audit approach, or in one case, were described as simply “off the wall” because they had completely misjudged what that company finance director was looking for.

In a connection between relationships at the start of the tender and behaviour during the proposal there was evidence of acceptance that the nature of interaction was impacted by what had gone before. For example four interviews identified that interactions were easier where they knew the firms involved; whilst there was also an appreciation that meetings were different for incumbent auditors, for example they asked fewer questions as their knowledge was greater.

### **Teamwork**

Although not mentioned as many times as the other main behavioural influences considered in the preceding sections, teamwork demonstrated by the firms was again identified as an influence on auditor selection (11 cases). This was consistent with Phase 1.

In Section 5.5.4, the frequency of comments made in relation to the influence of the final presentation was noted as they related to assessing teams and their propositions. A similar preponderance of comments were also identified in relation to the final presentation in considering teamwork. Four of the 11 interviews that talked about teamwork did so in relation to the firms' behaviour in the final presentation and how well that worked as a team in that session. In addition to these general observations the way that responsibility for answering questions was shared around between the team was also specifically noticed. It was also noticed where there was a weakness with an overseas partner who came across as subservient.

Teamwork was however not only observed in the final presentation. One Financial Controller observed when a team did not get on through a proposal process. Another contrasted a team that gelled as a team with another where, primarily through the body language she observed, it was obvious to her that the lead partner was unduly dominant in the team. Another similarly observed where people sat in meetings was indicative of how they worked together as a team. One financial controller observed that:

*The first meeting had seemed like the [Partner A] show. There had been ten minutes on [Partner A and him talking about his firm]. In the first meeting there had been breakout sessions so [Group Financial Controller] didn't see much of some of the team".*

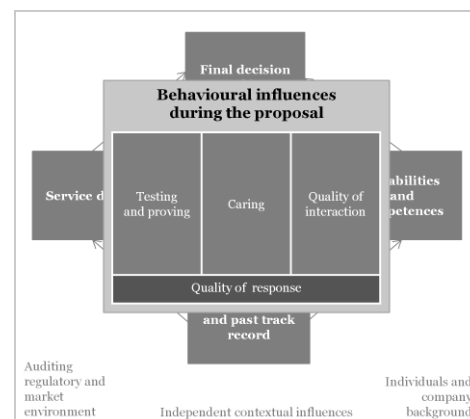
There was one exception where a finance director was indifferent to teamwork. He was impressed that one lead partner freely admitted he had never

met any of the global team and was proud of that because he argued it was better to identify the best people for the audit and not just people he knew.

That concludes the Phase 2a consideration of the quality of interaction during a proposal process which highlighted influences on auditor selection from personal chemistry, connecting on the right agenda and firms demonstrating teamwork. The final aspect of behaviour considered here is the influence of how well firms responded to the specifics of the invitation to tender.

#### 5.5.4. The quality of response

This final area of consideration of behavioural influences on those selecting auditors covers the general quality of the proposal processes conducted by the competing firms and how well they met companies' expectations. This covered the proposal processes as a whole including meetings, proposal documents and presentations. Because the logical flow of a proposal is from meetings to documents to presentation the results have been set out in that order.



#### Meetings

In relation to meetings the quality and thoroughness of preparation that had been undertaken by the firm impressed companies (six instances) and counted unfavourably when it was not observed (one instance). Companies were also impressed by the quality of the materials produced by the firms and used

during meetings being assessed (three instances). In one case a financial controller indicated that this was formally scored as part of the overall tender score sheet.

In addition to individual meetings, companies also commented on the relative performance and consistency of the competing firms across the meetings process as whole (three instances); they were in two cases, impressed by the way that the firms organised a thorough and well managed meetings process.

Lastly, in relation to meetings, there was discussion about the influence of firms seeking to break the rules and engineer meetings outside the formal process (six instances). There was no consistency in relation to the influence that this had on companies. For one organisation, where a contact had been initiated to check the team outside the formal process, this had been perceived very negatively. Others were however less concerned. For one company a formal strict process had been designed but firms were not disadvantaged by going beyond it. In a further instance a group financial controller was happy to have further meetings as long as they were interesting.

### **Proposal documents**

In relation to the proposal documents, 14 interviews included reference to aspects of the perceived quality of tender documents received. Positive views were expressed when documents clearly answered the questions in the invitation to tender and were clearly structured or formatted (six instances). Other favourable comments were made more generally about the high quality of



the documents submitted (three instances) and how documents had been professionally put together (three instances).

There was however some difference between companies' expectations as to the overall length of the documents submitted. Whilst five interviews identified short documents being received positively or longer documents being considered too detailed, in two others identified that the documents submitted were not detailed enough. Two others appreciated the professionalism of detailed tender documents.

### **Presentations**

There were 11 interviews which discussed the general quality of presentations. Companies noted positively where they perceived that the presentations were properly rehearsed (five instances) and were impressed by the obvious effort that had been put into rehearsals. By way of exception, there was one interview where firms were criticised for over-rehearsing. In a further three cases comments were made about how presentations were generally impressive and in two other cases how well they were structured.

So for the meetings, documents and presentations, companies were observing how well firms generally had responded to the invitations to tender in arriving at their auditor selection decisions.

That concludes the findings from the Phase 2a interviews as they related to behaviour. The next section considers the decision dynamics surrounding auditor selection.

## 5.6. Final decision making

The fifth and final decision influence within the revised conceptual model is the Dynamics of final decision making.

During this phase there was again evidence of companies' commitment to a fair and proper proposal process. In total 12 interviews highlighted extensive processes. Within this group seven had dedicated a proposal manager to running the process and twice external consultants were involved. Seven interviews talked about substantial investments of time being dedicated to the tender and commonly more than was anticipated at the outset. There was also explicit commitment to fairness (five instances).

In comparison only four companies talked about a short process but even then that was relative and the underlying tender still involved investment of time by both companies

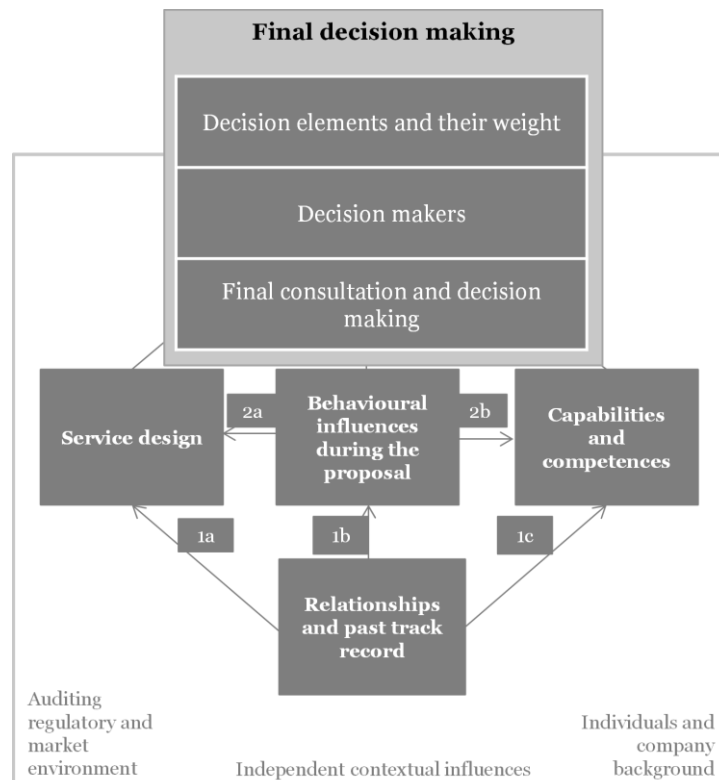


Figure 18: Phase 2a Final decision making influences on auditor selection

and the prospective auditors. In eight cases, companies acknowledged that the long auditor tenure they had justified taking the tender seriously.

In every case the final decision was taken after final presentations, but in some cases, companies shortlisted down to a final two either after receipt of proposal documents or after a first round of shortlisting presentations. There were only two cases where Mid-Tier firms were invited. In one of these cases, the relevant firm declined to tender.

The dynamics of decision making were discussed in 22 of the 23 company interviews and the three decision influences highlighted were again the elements of the decisions process (meetings, documents, presentations) and their weight, the decision makers and the final consultation process.

The sources and references identified for each of these are set out in Table 22 and considered in turn.

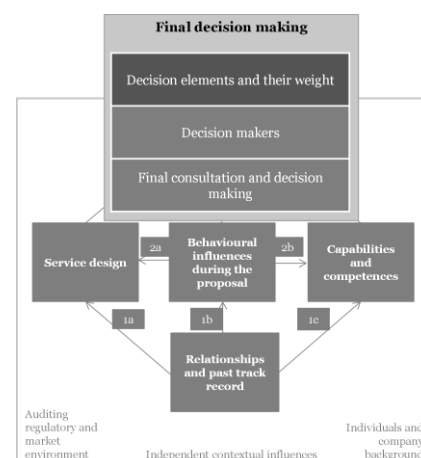
Factors	Sources	References
Decision elements and their weight	23	112
Decision makers	21	75
Decision consultation	20	67

Table 22: Phase 2a sources and references for Final decision making

### 5.6.1. The decision elements and their weight

The influence of the various stages of the proposal process was discussed in each of the 23 company interviews.

During Phase 2a the part of the process most discussed was the meetings that took place during the proposal process. Although some saw them principally as opportunities for



the firms to gather information (four instances) there was much greater discussion about their influence on the selection decision (14 instances).

Companies talked about gathering feedback from each meeting (eight instances) and about scoring or ranking the competing firms' performance in meetings (six instances). The feedback from the meetings became critical to the decision in four cases involving companies with international operation. In these cases important members of the companies' local management teams voiced strong concerns about one or more of the firms. These people might not be present at the final presentation and subsequent decision discussion, but carried sufficient weight for their views to be taken very seriously. For example:

*Group Financial Controller: "In a way it was decisive what happened at that stage. The feedback from the [major territory] management team was very one-sided in that one of the firms got fairly consistent negative feedback and because we had such a formalised process of getting feedback and we'd said upfront that the [major territory] resource piece was the number one factor ... it was actually very difficult to reach a different conclusion"*

Even where there were no critical views expressed locally, the meetings and subsequent feedback were used in the final decision discussion. This helped the selection panel to gain an overall picture of how the firms compared and in particular where there may be weaknesses that needed to be explored in the final presentation.

The meetings were therefore important and could be critical.

The presentations were the next most discussed element of the process (13 instances). These presentations were considered important or very important generally (six instances) and the discussion also provided evidence as to why they were important.

The presentations were considered important as the final “product” (three instances) and were critical where firms were seen to be “neck and neck” (two instances). The presentations also involved senior people who might not have been involved in the process up until then (two instances). Firms could also exclude themselves with a poor performance (one instance).

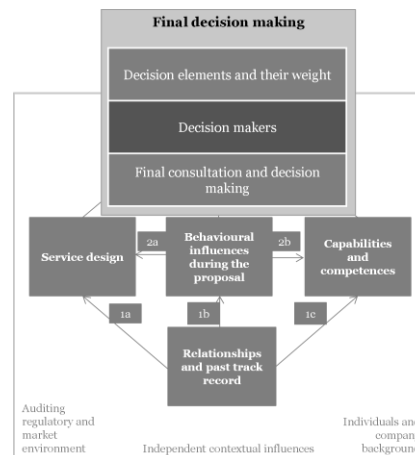
Not everyone saw the presentations as most important. For some the meetings were more important and the final presentation was largely confirmatory of what had gone before (four instances). A very good presentation was also not seen to override previous poor performance in meetings (one instance).

Where the importance of the proposal documents was discussed there was a split of opinion. For those who thought the document was important (five instances) it provided evidence of a well thought through approach, demonstrated that firms had listened and highlighted differences in competences between the competing firms. For those who felt it was unimportant relative to other aspects of the process (three instances) it was directly compared with the presentation which was for these people, more important.

### 5.6.2. Decision makers

The composition of the selection committee and their relative influence was discussed in 21 (93%) of the interviews.

The selection committee always had participation from members of the audit committee and the companies' management, but the balance between them varied with perhaps, given the regulatory backdrop, a much larger influence of financial management than might have been expected as compared to the audit committees.



There was a high level of discussion of audit committee involvement in the selection decision (20 instances) and in particular the audit committee chair was normally actively involved (13 instances). Management however were very active (14 instances) either because they were running the process, summarising feedback and reporting to the audit committee (in some cases making a recommendation to the audit committee) or because they were influential in the final decision discussion itself.

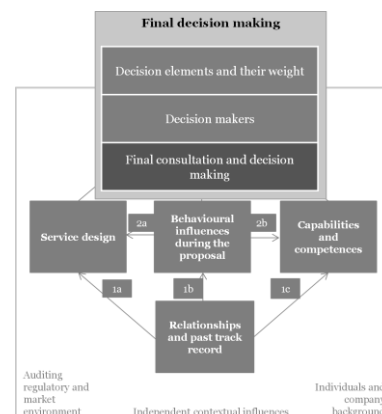
There was evidence of especially the Finance Director having an important role. The range of influence varied between involvement in the decision through to being seen as the prime decision maker. In one case an audit committee chair only met the finance director's choice of audit firm in another the finance director orchestrated the process. The following reference illustrates this point:

*“And I guess you know it’s about making sure that everyone else is comfortable with that decision. So I led the tender, I led the decision process and I made sure my Audit Committee Chair was happy, the Chief Exec, Chairman was [sic] happy and then we told the rest of the non-executives and the rest of the Board”*

There was therefore a balance of influences involving the audit committee but in most cases, only or mainly its chair and management. The nature of the discussion that took place between these groups is considered next.

### 5.6.3. Final consultation and decision making

There were two principal elements identified in relation to consultation. Firstly how close the decision was (making it either easier or more difficult to come to a decision) and secondly the nature of the discussion that took place in reaching a decision. There were 20 interviews which discussed this influence on the selection decision.



In 10 cases people considered the decision to have been close. In eight cases people talked about a lack of differentiation because the propositions were considered highly comparable or the same (four instances); or that all of the offers were very good (three instances). In comparison only three instances were identified where interviewees believed the decision to be clear cut.

Although the decisions were close, there was little evidence of disagreement or difficulty in reaching a decision. There was collective evaluation, with the use of scorecards as a basis (but not a final driver) (seven instances) and evidence of a lot of consensus (five instances), collective approaches (five instances) and a “collegiate” approach (two instances). Where there was disagreement this was resolved by debate (two instances) and in one case where there were initially quite different views, additional documentation was produced to attempt (successfully) to facilitate an end to the impasse.

### **5.7. Relationships between the factor groups**

As noted in Chapter 4, although the research design was focussed on identifying influencing factors a number of interesting indications started to emerge about how the factor groups influencing auditor selection identified might interrelate.

The influence of past service problems on future service design was noted in Phase 1. This phase also identified a number of benefits of past relationships affecting assessments of service and behaviour. Knowledge and trust developed delivering other services to the company, or through providing services at another company, appearing to influence companies’ assessment of firms’ abilities to serve them as they would want and with the right capabilities and competences. Furthermore past behaviour created expectations about current and future behaviour.

Behavioural influences during the proposal process also appeared to affect other factors. The two-way testing by firms of their ideas and by companies of



people and propositions appeared to influence both service design and capability and competence assessment.

Finally the Service designs which firms developed, the behaviour they exhibited during the proposal process and the capabilities and competences they put forward fed into the final decision making process.

## 5.8. Summary and conclusion on Phase 2a

This chapter has set out the findings of Phase 2a of the current research which involved 23 in-depth interviews with those within FTSE 350 companies who had recently been involved in an auditor selection decision. The analysis

was conducted in accordance with the research approach set out in Section 3.2.4 above.

As a result of Phase 2a a revised conceptual model of FTSE 350 auditor selection has been developed

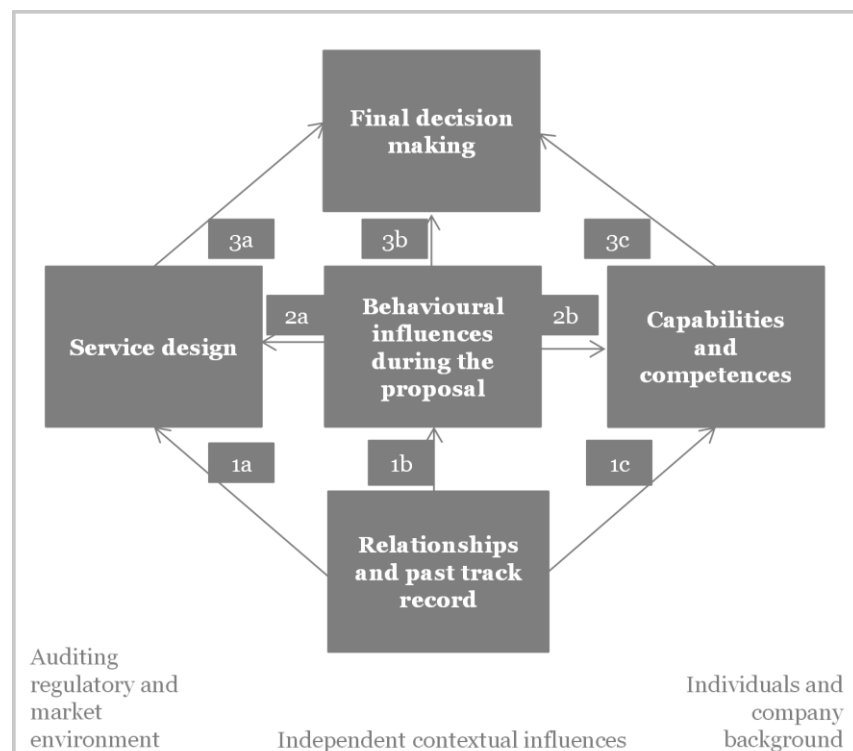


Figure 19: Revised conceptual model

Phase 2a identified the same five factor groups as the previous phase, that were influencing the auditor selection decisions of FTSE 350 companies. These were: Relationships and track record (at the start of the proposal process), Service design, Capabilities and competences (of the competing firms and teams), Behavioural influences (during the proposal process) and Final decision making.

In addition Phase 2a has also provided indications of the relationships between the five factor groups as shown in the numbers contained within the Conceptual model. These are: firstly, the influence of Past relationships and track record on Service design (1a), Behavioural influences (1b) and Capability and competence assessment (1c); secondly, the influence of behaviour during the process on Service design (2a) and Capability and competence assessment (2b); thirdly, the influence of Service design (3a), Behavioural influences during the proposal (3b) and Capabilities and competences assessment (3c) on Final decision making.

### **Relationships and track record**

Within the relationships and prior track record factor group the important influence of the relationship the company has with its incumbent auditor was identified. This phase did not however support that relationships between companies and their auditors were necessarily problematic at the start of the tender process. As many interviews discussed positive relationships as poor ones.

The research however did support the presence of other factors inherent to the incumbent auditor situation which also put them at risk. These included the attractiveness of new ideas which the incumbent might have difficulty in introducing because of the challenge of “why not before?”

Against these disadvantages were again weighed incumbent knowledge and the potential risk and disruption associated with auditor transition; although the latter was also counteracted by the attractiveness of a fresh approach and detailed transition plans submitted by challenger firms. These were seen to mitigate concerns over transition.

### **Service design**

At the core, companies were valuing rigour and assurance in considering auditor selection whilst the augmented service consideration included facilitating services associated with the audit. These were the working relationship, coordination and communication associated with the audit, accounting technical matters (especially dealing with accounting issues), the approach to the audit of IT systems and controls and how auditors proposed to work with internal audit departments.

Companies were also looking for ideas and insights from their auditors based on their broader knowledge and experience.

Fees were found generally not to be a major influence on auditor appointment. This arose either because the fee quotes were close, because companies felt the fees unimportant as they represent a small proportion of

total spend, or because negotiations took place after the decision or as part of the decision with the preferred bidder.

### **Capabilities and competences**

Capabilities and competences were found to be influences on auditor selection and operating at three levels: the firm, the team and the lead partner. In this phase most discussion related to the team. The assessment of teams was being undertaken at the individual and team levels with industry experience and expertise again being highlighted. Companies were also keen to understand how the team was structured.

The focus on the experience of the lead partner along with an assessment of their ability to deliver the audit along with their personal styles was also identified.

The firm was discussed less but the main issues included industry expertise, global reach and conflicts with other services.

### **Behavioural influences**

Behavioural influences were identified which appeared to go way beyond submitting a professional and compliant bid, although that was also an influence.

The main behavioural influences from Phase 2a underlined the importance of affect. The quality of interaction between the teams and the companies including personal chemistry was the most discussed behavioural influence on auditor selection. Companies also value the effort and enthusiasm that firms

put in and how they listened and responded to what they heard. Lastly, Phase 2a supported the presence of a process of testing and proving going on during a proposal process. Firms were testing and proving their ideas and propositions whilst companies were testing the propositions put forward by the firms and their competence; the latter especially in the final presentation.

### **Final decision making**

Phase 2a supported that the final decision was typically not made until after the final presentation, although it typically evolved during the process. The influence of meetings during the tender was identified as important both because it drove the feedback that was collected at the centre and because it started to form opinions. Presentations were also influential as the final stage of the process and often involved senior people; some of whom had not previously been involved.

In most cases this decision discussion immediately followed the final presentations although consideration was given to meetings including feedback from those not present at the final discussion, the documents and the final presentations.

In the majority of cases decisions were close but the final discussion consensual between the selection panels, which included both non-executives and executives. Audit Committee Chairs were involved but there was also an influential role for management; especially the Finance Director.

### **Relationships between the factor groups**

Although focussed on identifying the factors affecting the auditor selection decisions of FTSE companies, this phase of the research also started to identify relationships between those factors primarily: the influence of Relationships and past track record on expectations about Service design (1a), behaviour (1b) and Capabilities and competences (1c); the influence of behaviour during the proposal on Service design (2a) and perceptions of Capabilities and competence (2b) and finally the influence of Service Design (3c) Behavioural influences during the process (3c) and Capabilities and competences (3c) on Final decision making.

That concludes consideration of findings in Phase 2a and consideration of the two buy side phases of the research. In the next chapter the findings from the sales-side interviews is set out.

# CHAPTER SIX

## RESEARCH FINDINGS: PHASE 2b

### IN DEPTH SEMI-STRUCTURED INTERVIEWS

#### WITH BIG 4 FIRM PARTNERS

#### JUNE 2010 TO SEPTEMBER 2012

### 6.0. Introduction

In line with the phased approach explained in Section 3.2 this is the third and final chapter setting out the findings of the data relevant to answering the research question:

*“What are the factors affecting the auditor selection decisions of FTSE 350 companies in competitive tenders?”*

In the previous chapters the findings of the analyses of interview records obtained from a Big 4 firm (Phase 1) and of in depth interviews conducted with those involved in auditor selection decisions by FTSE 350 companies (Phase 2a) were considered. This chapter now provides a different, sales side, perspective on the

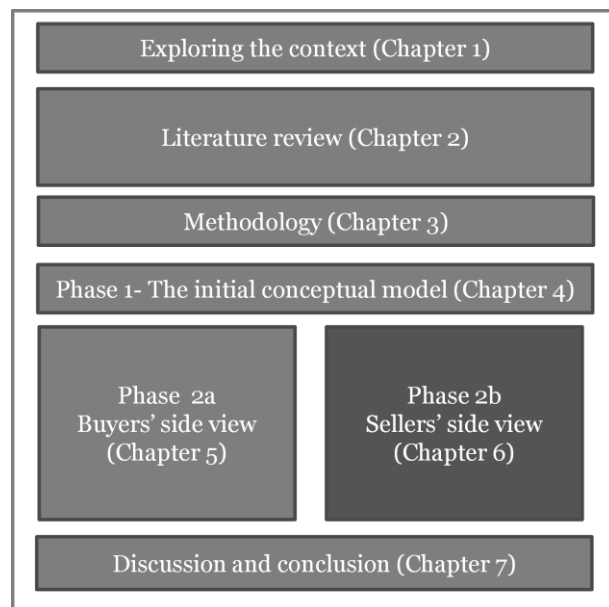


Figure 20: Phase 2b within the overall research approach

auditor selection decision by setting out the findings relating to views of the partners involved in 12 of the 17 audit tenders included in Phase 2a.

### **6.1. Analysis of in depth interviews with those involved in an auditor selection decision by a FTSE 350 company**

This final phase of the study (Phase 2b) sets out the findings following the analysis of in-depth interviews conducted with Big 4 audit partners who had recently, at the time of the interview, been involved in a proposal for the audit of a FTSE 350 company.

Consistent with the first two phases of the study, the analysis was conducted in accordance with the approach set out in Section 3.2.4. Across the 24 in depth interview records, 560 nodes were identified and 1465 references were assigned to these nodes. This represented a similar number of nodes to Phase 2a although the references were fewer at an average of some 61 per interview. The overall number of references was less than Phase 2a notably in connection with discussion of the final decision making. This is understandable given that they would not have had sight of the final decision making.

The findings from Phase 2b, however, demonstrated a high degree of consistency with the other phases at both the factor group and individual factor level and supported the revised conceptual model set in Figure 13 in Chapter 5 and reproduced in Figure 19. For convenience the model is set out again below as Figure 21.



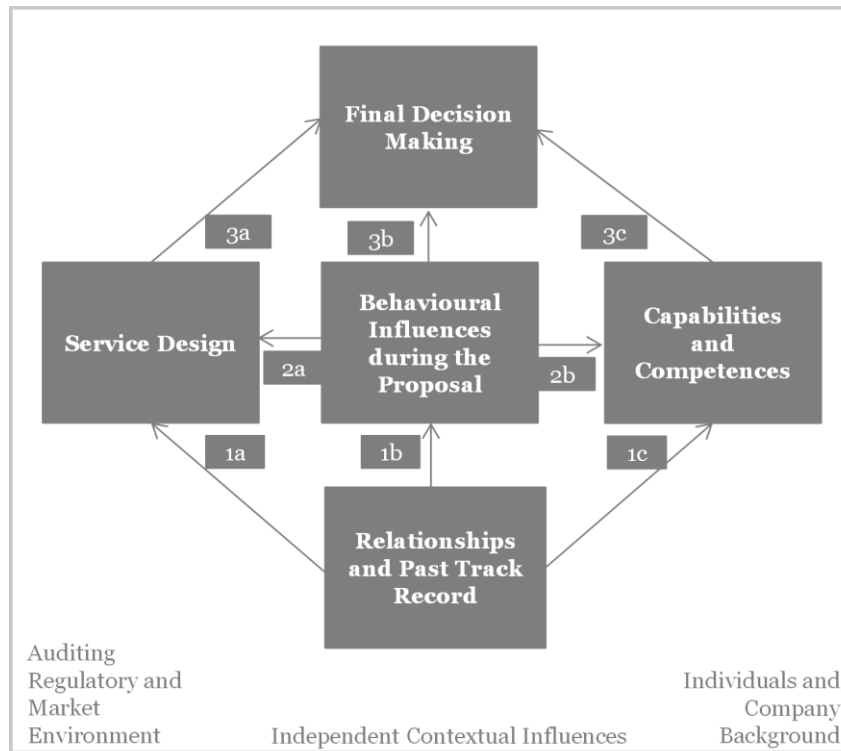


Figure 21: Revised conceptual model

The analysis of the Phase 2b interviews also provided additional perspectives in some areas, especially around the interaction that took place during the proposal processes. As will be expanded below, discussion of behavioural influences on auditor selection was especially frequent, whilst service assessment was comparatively less frequently discussed.

As in the previous two phases, the five factor groups influencing audit selection identified were: Relationships and track record (at the start of the proposal process), Service design, Capabilities and competences (assessment), Behaviour influences (during the proposal process) and Final decision making.

The findings from Phase 2b of the study are now discussed in turn for each factor group in the five sections which follow.

## 6.2. Relationships and past track record

The partner interviews supported the importance of relationships at the start of the tender process and consistent with the previous two phases the types of relationship and track record influences on auditor selection were very similar.

These are set out in Table 23 and featured positive and negative influences pertaining to

auditor incumbency, the influence of a track record of other non-audit services and targeting activity, the influence of alumni, relationships at other companies.

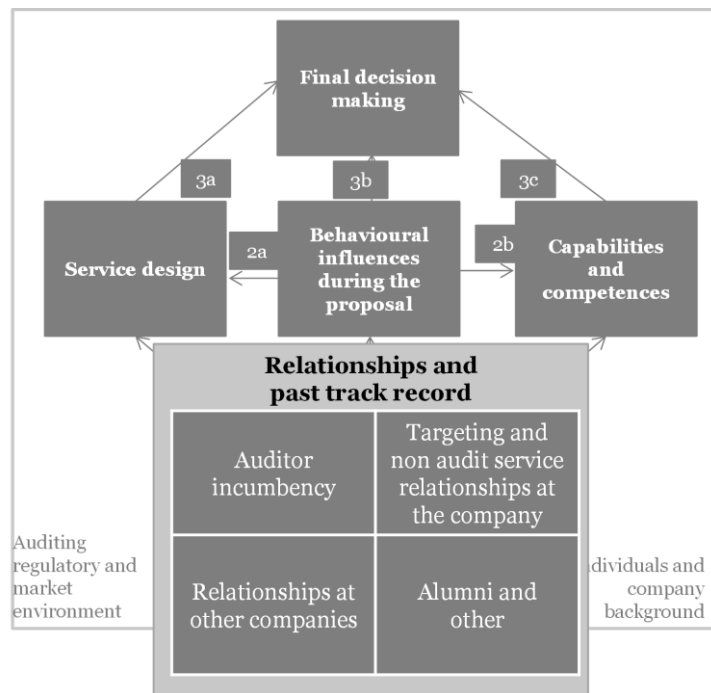


Figure 22: Relationships and past track record influences on auditor selection

Subcategory	Sources	References
<b>Audit firm incumbency</b>	<b>21</b>	<b>118</b>
• Past service problems	16	34
• Positive track record	10	13
• Incumbent inherent disadvantage	11	39
• Incumbent inherent advantage	7	18
• Auditor transition	10	14
<b>Non-audit track record and targeting</b>	<b>19</b>	<b>111</b>
<b>Alumni</b>	<b>13</b>	<b>24</b>
<b>Past and current relationships at other companies</b>	<b>11</b>	<b>35</b>

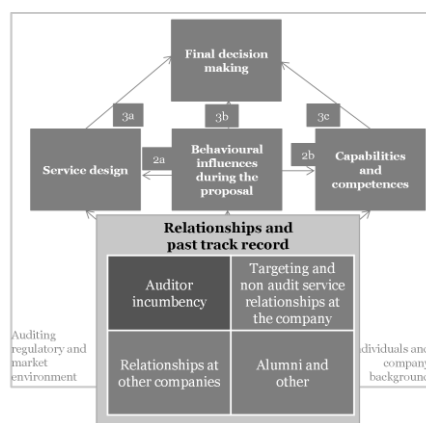
Table 23: Phase 2b Relationships and past track record sources and references by factor

The Phase 2b research findings in relation to each of these factors are now considered in the following sections in descending order of the number of

interviews which discussed them. The position of the incumbent auditor is therefore considered first. The influence of targeting and other service relationships at the company is considered next, then the influence of alumni of the Big 4 firms and finally relationships at other companies.

### 6.2.1. Audit firm incumbency

The partners talked about the important influence on the auditor selection decision of the relationship of the company with its incumbent auditor (21 instances). Consistent with the first two phases of the research there influences on auditor selection came from the



service track record of the incumbent, influences arising from the inherent situation of being an incumbent and lastly matters relating to auditor transition.

### Incumbent service track record

Both positive and negative influences were identified for the incumbent in relation to their service track record. As Table 23 shows however there were many more interviews containing references to past service problems than to positive track records and more interviews highlighting incumbent inherent disadvantage compared to incumbent advantage. The interviews included situations where the partners themselves were the incumbent, where the partner was new, but the firm was incumbent, and where another firm was the incumbent and the partner was challenging for the audit.

There were 16 partner interviews (67%) which highlighted problems with incumbent track records; a very high proportion of the whole population. Although the position is complicated here to some extent because in five of those interviews partners discussed both positive and negative aspects of the incumbent auditor's track record, nevertheless the balance of discussion was more negative than positive.

In 11 of the 16 interviews referred to above, partners talked generally about the dissatisfaction they had identified with the incumbent auditor and/or their service. In these cases partners talked about the influence it had on the interactions that took place during the proposal process. This included companies spending time talking about their frustrations with their incumbent auditor. One partner thought this just reinforced the company's feeling of dissatisfaction by keeping it front of mind.

*“And I think they were very open as I say, giving with their time, quite happy to discuss the issues, most of which were about how [bad] [incumbent firm] were so actually in the early days we had very little opportunity frankly to demonstrate our own value. It was all about beating up the incumbent and we sat there quietly and just kind of sagely nodded and tried not to agree too much”*

Hearing about incumbent problems helped partners shape their own responses; ensuring that their own service propositions dealt with the frustrations identified.

As well as the discussion in general terms certain specific areas of dissatisfaction were also highlighted. These included incumbent auditors having become complacent (three instances), disputes over fees (three instances) and missing or not dealing with issues (three instances).

Two interviews talked about a specific situation where a senior partner of an incumbent auditor had actually apologised for past actions. In this case the apology had been critical to the retention of the audit by that incumbent. It was thought important that the company was confident that a set of particular circumstances which had damaged the relationship between the company and its auditor would not be repeated.

In comparison with the high proportion of interviews highlighting problems with auditor track record, the instances of a positive track record were much fewer. Although in total there were 10 interviews which identified positive influences relating to the incumbent service relationship, as noted above, in five cases these arose in interviews which also discussed negative influences. Where partners talked about the positive influence of incumbency, in most cases (eight instances) they talked about relationships rather than service. These included examples of teams having strong relationships with their clients generally and strong individual relationships between the auditors and directors and senior management. In one case a partner explicitly identified the positive relationships which existed before the tender being the critical factor for success. In another the relationships that an incumbent had provided the platform to evolve the audit service and defend the audit appointment; dealing with the service concerns that had been identified.

### **Incumbent inherent position**

As discussed in the earlier phases of the research the position of the incumbent at the start of a proposal process was not however affected only by their track record. There are also inherent advantages and disadvantages. And again here the disadvantages (11 instances) were more often than not seen by the partners to outweigh the advantages (seven instances).

The forces for change identified in the previous phase(s) were also seen to be present by the partners. These included changes in key company directors (four instances) such as an audit committee chair, finance director or, as in one case, several changes of members of the board. In these cases new people were either looking for change as part of a more general change programme or had different attitudes to tendering. For example where new people who believed tendering was a good thing (even where there was no dissatisfaction) replaced those who saw less value in it.

As well as changes in key people, change in the company's business was also considered by the partners to create an atmosphere which favoured a change of auditor (four instances). This was the case in two particular companies. In the first of these companies, there had been a substantial and negative business event which had left the company under severe financial pressure. There was in this case an element of the auditor being guilty by association. Having been present during the problems the view was "How could they not have identified the issues and helped prevent the problem?"

In the second case the company had made a transformative acquisition which had increased its size very considerably and meant that the audit arrangements would need to be different anyway. The company's view was: why not take the opportunity to review the relationship as a whole and identify a new auditor for the new situation?

There was also evidence of incumbent auditors acknowledging the inherent difficulties they may face in an audit tender and preparing ahead. This had led to changes in the service team to introduce new people offering fresh approaches to combat the inherent attraction of change (four instances). In one case this extended to presenting a new audit plan with new ideas, similar to a proposal document, ahead of the tender process.

The challenge for an incumbent to come up with new ideas against the backdrop of an established service relationship was also identified again. In one case, a partner even felt it was necessary for an incumbent to come up with surprises. In another case, a challenge was identified for the meetings during the proposal process. For many, these meetings would be about the audit firms fact finding. Incumbent auditors however would be expected to know everything they needed to know to perform the audit. How would they demonstrate interest in this situation?

There were seven interviews which identified incumbency as an inherent advantage in audit tenders. Some felt that companies would need a reason to change in order to outweigh costs and disruption of transition and that there would be a tendency to stay with the incumbent *ceteris paribus* (three cases).

Why would a company change and incur the potential disruption of transition if this was not necessary or obviously beneficial? At any given time a company would also be coping with other changes affecting its finance function. One partner talked about the importance of potential auditor change needing to be effected in the context of a lot of other changes going on at one particular organisation.

Others saw incumbency as an advantage because it gave that firm access to the tendering company and its key officials in the run up to the proposal (two instances). This regular contact would facilitate maintaining relationships and testing new ideas in the course of normal business and in a way that was not open to others who would be constrained by the rules of the tender process.

Only two interviews identified loyalty to the incumbent firm as an influence on auditor selection. This low level of discussion is consistent with the previous two phases of this study.

Lastly, in relation to the inherent position of the incumbent, partners found it difficult to assess their position when a tender was being driven by corporate governance (five instances). In particular partners found it difficult to assess whether the corporate governance agenda would be satisfied by the tender alone or whether there was an underlying feeling within companies that there had to be a change. For example one incumbent partner commented:

*“There are two possible interpretations of this... you know it will be an absolutely level playing field and we stand every chance of winning or it’s being put out to tender with a presumption for change because that is the*



*interpretation being put on FRC guidance.. we will never know and you might not know at the end of the process”*

### **Audit transition**

The last area of analysis relating to the incumbent auditor is audit transition. In total 10 interviews identified a variety of specific transition influences on the selection decision. (NB this section restricts itself to consideration of specific references to issues about the actual act of transition). There are also likely of course to be broader relationship influences which influence a company's appetite for transition. These were discussed earlier in this section.

Three interviews discussed transition as a concern for companies. In one case an individual finance director had appeared to be against change and seemed to prefer to reappoint his existing auditor over concerns about a new firm getting up to speed. In another, a partner suspected that there may have been a concern about a new firm taking a different view on a company's accounting judgements. In the third case, any transition would be coinciding with the transition of an audit committee chair. The company was nervous about the transition and especially with its coincidence with this important board change.

Three further interviews discussed companies exploring the transition by asking questions in proposal meetings or presentations; confirming how things were going to work in areas of interest.

Transition did therefore appear as a concern, however one partner felt that it would not be successful for an incumbent just to assert that transition would be too difficult and disruptive. This had happened on the proposal that he had been involved with and it backfired for that incumbent as other firms were offering new ideas and approaches.

In this phase aspects of transition preparation and planning were also discussed. This was raised in seven interviews. In three of these interviews partners talked about the detailed transition plans that had been prepared so that the firm was ready to start should they be appointed. One further interview raised the importance of previous transition experience in the team. Finally two interviews identified the role of the secondment of a member of a firm's staff to the tendering company. In one case, a secondee prior to the tender was proposed to help facilitate the transition. In another, a firm identified a separate transition manager who they offered to second to the company to help with the administrative aspects of the transition.

Overall the partner interviews showed a number of consistencies with Phase 2a with transition identified as a concern for companies, but one which firms sought to mitigate with detailed transition plans and support.

So, consistent with the previous two phases, the incumbent auditor starts in a unique position. In the auditor selection context the partners saw this, more often than not, as a negative position which of course contrasts with some of the literature in this area.

Other firms however also had established relationships and this is discussed in the next section.

### 6.2.2. Targeting and non- audit service relationships at the company

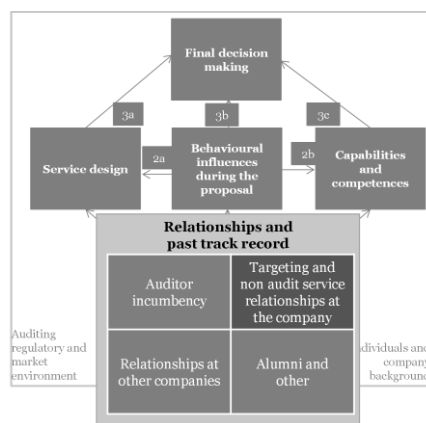
The partner interviews identified a range of non-audit relationship matters which they considered to have influenced auditor selection. These related to other service relationships and targeting activity (as previously defined in this context in Chapter 4).

#### Targeting

In addition to past services, 14 (58%) of the partner interviews also talked about investment in relationship building or targeting ( as previously defined) ahead of the proposal.

The positive influence of contact ahead of the proposal process was identified (nine instances). Interestingly in every case the initial contact of the audit teams was facilitated by others with existing relationships with the companies or

individuals concerned. Contacts arose from a number of different sources including the non-audit service relationships mentioned above, contacts from other companies and in three cases as a result of past unsuccessful audit proposals where contacts during those processes were sustained.



These (targeting) meetings tended to be discussions about the company's business or more generally getting to know people and often in a social setting such as over drinks or a meal or connected with a sporting event. In two cases however much more structured approaches were discussed, including global target team account planning workshops.

In three interviews partners talked about the challenges they faced in winning the proposal, absent such targeting activity, and one reflected on the opportunity lost before the proposal where there had been limited investment in relationships.

The importance of knowledge of the company and its business and people was also recognised by the partners (five instances). The impact of not having this knowledge was explained by one partner:

*“Because we didn’t know the client well enough we made some assumptions. We were forced to make too many assumptions and we didn’t get it right. We made an assumption about me and didn’t get it right, we made an assumption about [which office to use to conduct the audit] and got that wrong....I think we were probably forced to make an assumption about the presentation....we didn’t know how to be edgy and got that wrong”*

One of the tactics which had been employed to help build knowledge of a company and its business and relationships with its people was seconding staff to companies ahead of the proposal (two instances). This had proved successful in helping to provide valuable knowledge to their firms during the proposal process. In one case, a former senior employee of the target company was

employed as a coach to the team; helping them to understand how things worked within that organisation.

### **Other non-audit service relationships**

Where non-audit services were being provided by an audit firm, this enabled those providing those services to introduce their audit colleagues and help to start building relationships (four instances). Chapter 1 explained the change in nature of the Big 4 firms and how post Enron they typically provided non-audit service to companies who were not audit clients. Phase 2b identified a number of these service relationships at the start of proposal processes. They included tax advice and consulting (two instances) and advice in relation to director's remuneration and corporate structuring. One partner talked about such non-audit services creating confidence in the company that the firm could do a good job and this would extend to audit. Notwithstanding the strict independence rules referred to in Chapter 1, one organisation was still thought to view their relationships with their professional service providers as holistic; where individual services would not be considered in isolation but rather as part of a broader whole. Where individual relationships had been built through the provision of non-audit services, it was suggested by one partner, this made it easier in proposal meetings for those members of the proposed audit teams who did not have any such relationships. They were being introduced to the companies by members of their own firm who had existing relationships.

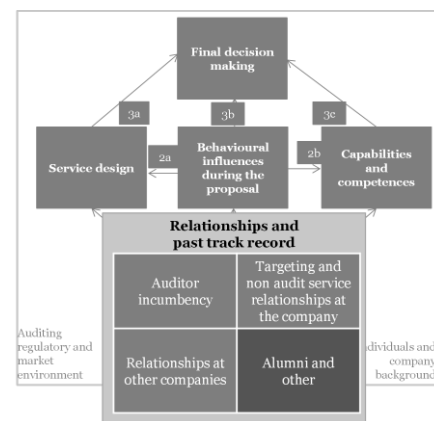
The past non-audit service relationship was however not always a positive influence for the firm involved. In one case, a successful tax relationship seemed

to have had little impact on the audit decision (the tax director effectively abstained). In another case some problems with a consulting assignment and a dispute over fees had caused friction. The audit partner brought in to resolve these problems had been earmarked to lead the audit proposal, but as a result of the negotiations to resolve the problem his relationship with the company suffered. As a result they suggested he should not subsequently lead the audit proposal for that firm.

The track record of working with a company therefore provided both personal contacts and knowledge, which proved useful in a subsequent audit proposal. The success or otherwise of the service history caused positive or negative influences on that auditor selection decision.

### 6.2.3. Alumni

The discussion of alumni relationships was more prevalent in Phase 2b than in the other two phases and identified in 13 (54%) of interviews conducted. The interviews also identified a more consistently positive view of alumni relationships and their influence on auditor selection for their former firms.



Partners talked especially about alumni providing advice before the proposal process and then feedback during it (eight instances). This happened in a number of ways. In one case the proposed team was discussed ahead of the proposal with a senior alumnus who provided views on whether they thought

people were strong enough and whether they would fit based on their knowledge of both the firm's people and the company concerned. In other cases the influence concerned providing additional background on the business and providing feedback on the firm's (although generally not the competitors') performance in meetings. In one case positive feedback on an early meeting motivated the team as one partner observed:

*"You know we got feedback within 20 minutes of that first meeting. They rang me when I was in the cab on the way back to say that went really well. So you take great heart from that and the team took great confidence from getting [alumnus] feedback after the second meeting. I think it helped all of us, absolutely everybody. So having moles is phenomenally helpful"*

In another case a partner observed that an organisation had several alumni from the firm and thought that their recruitment was evidence of the company's respect for the talent it had. They suspected that alumni may be recruiting people like them and this may well have also influenced their views on auditor selection.

The partners could of course only comment directly on the influence of the alumni of their firm because they had no direct access to what other firms' alumni were feeding back to their old firms. They did however suspect that there were also positive influences for other firms where alumni were in key positions. Two interviews talked about such situations and suspected it to be positive for those firms.

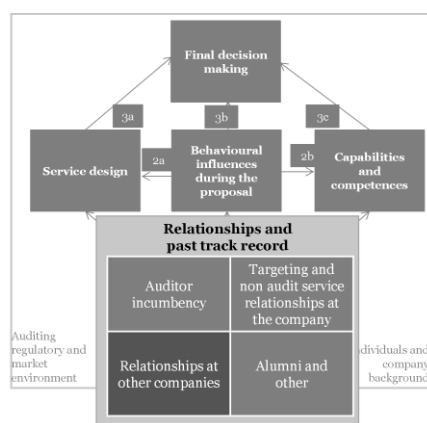
The positive influence of alumni was not however in relation to alumni voting for their old firms. It was more in the nature of using their knowledge to help them to get to a better proposition or generally to create a positive impression.

Alumni were however not universally positive. In two cases alumni were specifically observed not providing any comment or feedback in processes which had strict rules about this. In another case an alumnus provided no input having lost contact with the firm for several years.

The role of alumni as coaches to their former firms was therefore the most common theme of discussion. There was no discussion of alumni appointing or overtly lobbying for their former firms.

#### 6.2.4. Relationships at other companies

Phase 2b identified fewer discussions of any influence from relationships that the firms had with decision makers through connections or experience at other companies (11 (46%) of the interviews discussed this). Where it occurred however there were instances where it was very influential to auditor selection.



There were eight cases where directors had been audited by another firm at another company where they had previously been employed. In two of these



cases, partners considered these pre-existing relationships to be decisive in the current auditor selection decision. Indeed in one case, a recently appointed finance director supported the appointment of the individual audit partner who had led the audit at his previous company.

There seemed to be less influence where the previous relationships at other companies related to non-audit services. Where non-audit services had been provided by the competing firms at other companies, none of these relationships was identified as being influential to the selection decision (four instances).

#### **Current cross directorship influences**

There were five cases where directors were also currently directors of other companies where one of the competing firms was the auditor. It was not evident from the interviews whether such a presence was influential, but in no case was the connection associated with success for the firm concerned.

Consistent with the other two phases then, there was less discussion of the influences on auditor selection as a result of cross directorship relationships at other companies than there was in relation to past relationships affecting the tendering company itself.

#### **6.2.5. Trust**

Phase 2b identified trust as a positive influence on auditor selection (seven instances). Partners thought trust influential in two ways. Firstly through the individuals that were being proposed to conduct the audit. It was felt important

that behaviour in the run up to proposal (and during it) supported what was being said. One partner thought trust was built “in the execution”. (NB the examples highlighted in the previous section about working relationships at a previous employment may also support this).

Secondly in two cases trust that had been built by non-audit partners was considered to support the credibility of the audit proposal by creating inter organisational trust. For example one partner commented:

*I don't think you can overestimate how important the 10 year relationship with the firm before we go into tender. So [what] [Tax partner] and then what the team had done....that track record and trust...you can never overestimate its intangible but a key factor. Because they trusted us, we've helped them out, we've been in the trenches with them over ten years. They trusted us. They trusted [Tax Partner].*

The importance that partners assigned to trust and the relatively little discussion of it in the client interviews of previous phases is interesting. Partners may be overstating the importance of trust or alternatively companies may not be recognising something implicit.

#### **6.2.6. Other relationship matters**

In seven interviews partners talked generally about the strength of relationships which they or their competitors had with the tendering companies, providing further evidence that they considered it an influencing factor on the selection decision.

However as identified in one case significant supply relationships between the company and the firm (whereby the services bought by the firm from the company significantly exceeded the quantum of the audit fee) appeared to play no part in the decision. Although an audit firm was a significant customer of the company, this was discounted (or ignored) in the auditor selection decision.

The level of comment on references was also again relatively low with only three interviews referring to it; providing further evidence of the apparent relatively low influence of word of mouth in FTSE 350 auditor selection decisions.

That concludes the consideration of Phase 2b findings on the influence of pre-existing relationship on auditor selection. This phase provides further evidence of companies being influenced in their auditor selection decisions by the status of pre-existing relationships. These relationships were found to relate to those with their incumbent auditor, other non-audit service providers, (to a lesser extent) connections at other companies and through alumni relationships (especially with alumni as coaches to their former employers).

The next section now considers the influence of Service design.

### 6.3. Service design

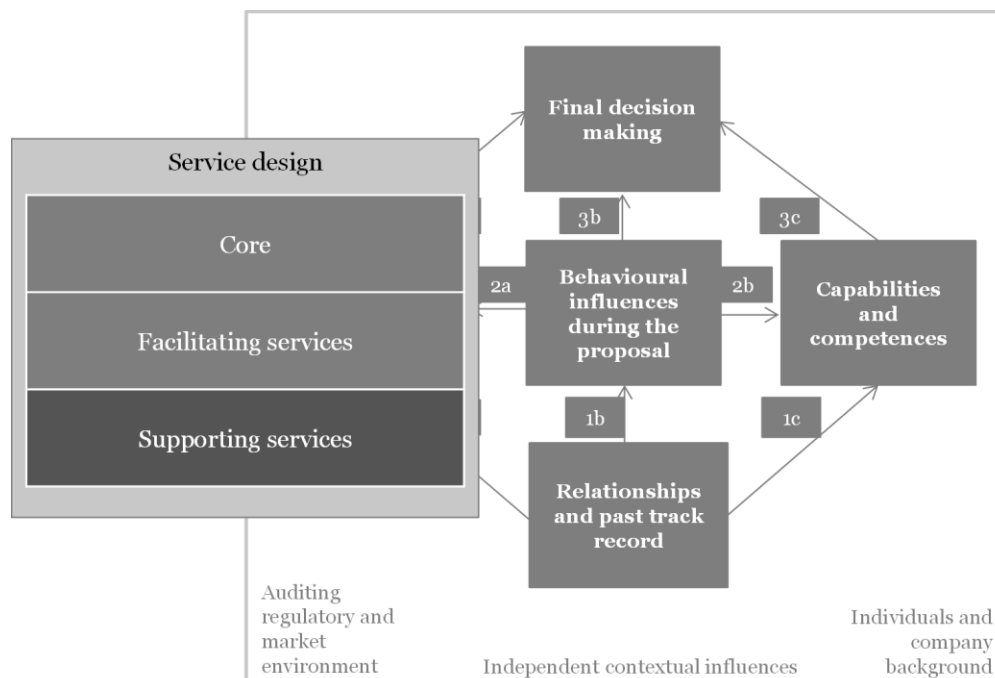


Figure 23: Service design influences on auditor selection

The analysis of the findings of partner interviews as they related to service design and assessment has been organised using the same service definition framework adapted from Gronroos (2007). As in the previous phases influences associated with the rigour and quality of the audit are classified within the core audit service. Influences associated with the way that the audit is delivered are classified as facilitating services. Those influences related to adding value above the delivery of the audit, but still part of the overall audit service, are classified as supporting services.

In the previous two phases there had been some discussion about whether it was possible to differentiate an audit overall within the Big 4. This section therefore considers the partners views on this first.

### 6.3.1. Audit approach, general differentiation and tailoring

The partners generally did not mention this during the interviews. It came up in only three interviews and in two cases partners recalled their prospective clients telling them that they were not differentiating on core audit. A quote from one partner illustrates the point:

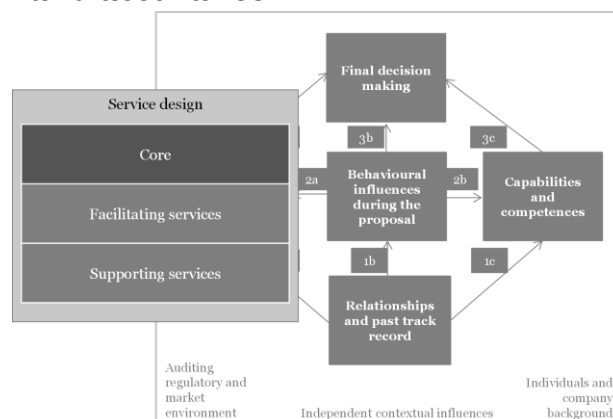
*“Approach?.....Guess what it’s an audit, they more or less said anyone can audit, you can all audit, all four of you, don’t care which firm. It’s a given so I don’t even want to talk about that”*

So, in contrast to the previous two phases the partner interviews provided little evidence of discussion of differentiation of the core audit and indeed some evidence that they thought companies felt the audit overall could not be differentiated between the Big 4 firms.

The interviews did however make frequent references to aspects of the audit. These have been organised in an order consistent with Phase 2a and are considered in the sections that follow using the same Gronroos (2007) framework; therefore starting with the core audit.

### 6.3.2. Core audit rigour and assurance

For this section the same definition of the core audit has been used as was explained in Section 5.3.1. and Section 5.3.2.



Reflecting the definition of audit quality outline by DeAngelo (1981), the core audit is defined here to include aspects relevant to auditors identifying and reporting (material) errors and therefore includes descriptions of attributes that would make this more likely (for example including such attributes as rigour and assurance (that there were no surprises)).

Eight interviews (one third of the total) referred to audit rigour and related matters. Within this group three partners talked about the importance companies placed on a robust or high quality audit and one that would not miss issues. For two others the focus was on the actual delivery of the audit at the centre of the proposal.

In addition, four other partners talked about discussions they had had with companies concerning the audit approach and how specific areas would be addressed (to confirm that adequate effort was being directed to ensure that errors would be identified). Where companies probed specific aspects of the audit partners felt it important that they were able to deal with the issues raised. In two cases, partners noted how a clear response had received a positive reaction. In another interview however, the audit team had been less clear about how they would approach a particular important area of the audit. The lead partner felt that had been an important and negative influence on the selection decision.

Finally, and consistent with the comments made above about inherent difficulties for the incumbent, one partner commented that it was very difficult to explain the audit in an interesting way where the proposal coincided with the

year end audit. In effect, the partner concerned felt he was trying to explain what the company already knew because they had just experienced it. This he felt put him at a disadvantage in the proposal process as he was being compared with other firms with new and different ideas (which might inherently be more interesting even if they were not better than the current service plans).

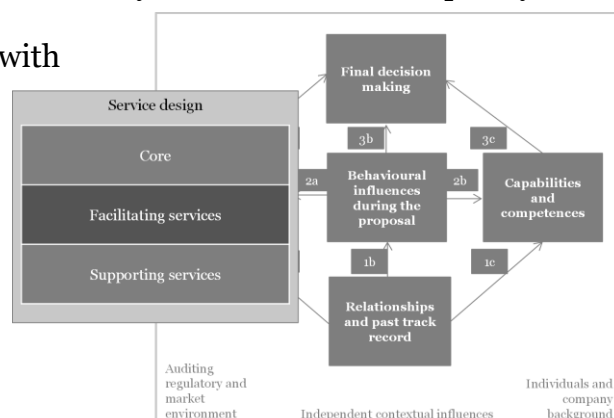
### 6.3.3. Facilitating services

The analysis of the Phase 2b interview data was consistent with Phase 2a and also identified five facilitating services influences on auditor selection. These are set out in Table 24 below along with the number of sources and references identified from the interview records for each subcategory.

Factors	Sources	References
The future working relationship	14	30
IT systems and controls	8	14
Coordination and communication	6	10
Accounting technical matters	4	8
Working with internal audit	5	5

Table 24: Phase 2b sources and references for facilitating services

Although these subcategories are the same as those identified in Phase 2a which in turn had a high degree of consistency with Phase 1 the frequency of discussion was somewhat different with similar numbers of interviews discussing the working relationship, IT systems and controls and internal audit but far fewer raising coordination and



communication and accounting technical matters. Each of these influences as they were identified in Phase 2b is now considered in turn.

### **The future working relationship**

The Phase 2b analysis highlighted 14 partner interviews which discussed the future working relationship. This category includes the softer areas of personal interaction as part of the audit as compared to the specific aspects of work design.

In five cases the partners spoke generally about how they thought companies were looking for positive relationships. In two further cases partners said explicitly that friendship was a selection influence. In two other cases references were made to other specific aspects of the relationship being sought; one partner felt hands-on support was important, another that a company was looking for a business partner.

Most commonly however partners talked about companies looking for people they could work with. There were eight interviews with comments related to this. In half of these interviews partners felt it was important that companies felt they could work with the individuals and teams put forward. In one case a partner expressed this as it being important for the proposing team to fit with the company's culture.

In three cases partners went further. The first thought it was important not only that people felt they could work with the teams put forward but that they actually wanted to. The second suggested that, in an environment of high



work pressure and a culture of long working hours, one company would want an audit team that it would be fun to work with. Lastly one partner felt that:

*“They would enjoy having us as their auditors, that’s my personal view of what we were trying to do. You will like working with us, we’ll enjoy working together”*

As noted in Section 5.3.3 there are of course connections here with personal chemistry and the quality of personal interaction which are discussed further below in relation to behavioural influences during a proposal process.

### **IT systems and controls**

IT and systems and controls as an influence on auditor selection was identified in eight interviews. The comments made by partners were split between the importance of firms being able to provide informal advice as part of the audit and recommendations as to how companies might improve their systems and controls as well as the audit approach to systems and controls.

Where partners thought input to improving systems and controls was influential to the selection decision in three cases, this related to the presence on the audit team of a specialist in the relevant accounting system being used by the company. In one of these cases where the company had a relatively immature systems and control environment, the ability to build a specialist review of systems as part of the audit was considered one of the critical areas underpinning the successful tender. In the other case the comment was made

more generally that helping a company to improve its systems and controls was one of the discussion points during the proposal meetings.

Where the audit approach was considered important, in two cases partners talked generally about the companies' desire for the audit to rely on their systems and controls. In one case however, a partner talked about it being critical to the selection decision and mentioned that it had been discussed in all of the meetings that took place as part of the proposal process. In this case the company was particularly dissatisfied with the approach that its incumbent auditor had taken and was determined to use the proposal to explore different approaches in this area.

### **Coordination and communication**

Coordination and communication were mentioned in six of the partner interviews although some of the comments were also quite short. Three potential influences on auditor selection were identified.

Firstly, companies were looking for the lead partner as the single point of contact for the audit and all of the service interactions that occurred. Secondly, in two cases, companies wanted effective global coordination. In one of these cases the particular issue was coordination in one of their specific global regions where they had meaningful operations across a number of different territories. Lastly in terms of communication, two partners talked about companies feeling communication was an important selection criterion and in one of those cases specifically continuous communication.

The relatively low levels of discussion about coordination and communication contrast with Phase 1 where this area had been considered problematic by companies and therefore influential in at least some selection decisions where companies had overseas operations.

### **Accounting technical**

In a similar vein there had also been substantial comment about accounting advice in Phase 1 (where comments related to problems that companies experienced in this area and how it affected their auditor selection decision) and in Phase 2a (where inter alia the need for discussion and the value of advice on the companies' annual reports were discussed) . In Phase 2b there were only four interviews which discussed accounting technical matters.

In one of these cases the partner described the discussions about accounting that took place during the proposal and how they felt the client valued the advice and perspectives provided. In two cases however a negative influence on the auditor selection decision was perceived to have occurred when partners were unclear in their discussions about accounting areas of concern to companies. In one further, case firms had offered different advice in relation to specific matters of concern to one company and it became influential on the selection decision when the incumbent's view was eventually agreed by all the firms to be the most appropriate one.

There is overlap here between accounting issue resolution being considered important by the partners and the testing of competence discussed in the behavioural influences on decision making sub section considered below.

### **Working with internal audit**

Lastly in relation to facilitating services, partners talked about aspects of the relationship with internal audit and their influence on the selection decision. There were five interviews where partners referred to this. In one case it arose as a reference to general comparisons being made about how well the firms' proposals supported internal audit. In another case a partner mentioned that an audit committee chair had expressed frustration in a meeting that one firm had not put forward proposals that he felt adequately supported and integrated with internal audit.

In three interviews, the discussion had been about the situation where one of the Big 4 firms was providing internal audit services as part of an outsourcing agreement. Auditors are generally not permitted to deliver external and internal audit services to the same company so, where a firm provides such internal audit services and proposes for the external audit, this is a matter that needs to be resolved. In one case, and related to the comments made about knowledge under relationships in Section 6. 2.2, the provision of the internal audit provided that firm with a strong base upon which to build and the company foresaw no difficulty in selecting that firm for external audit. This view prevailed even though their appointment would create a need for another internal audit outsourcing partner.

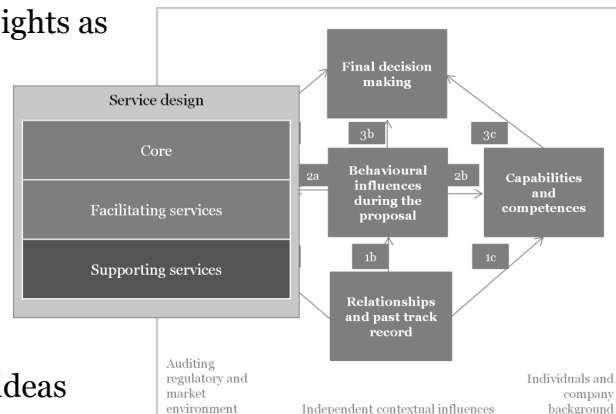
Elsewhere however, the internal audit outsourcing arrangement was problematic when that firm proposed for the external audit. The firm involved had attempted to extol the benefits of an integrated approach, but the company

wanted completely independent firms and so the incumbent outsourced internal audit became a negative influence for that firm in the external auditor selection process.

That concludes the consideration of facilitating services identified from the interviews with those involved in auditor selection. The next section considers the important supporting service identified and that is ideas and insights from the audit.

#### 6.3.4. Supporting services: ideas and insights from the audit

In Chapter 5 the high proportion of Phase 2a interviews which identified companies looking for ideas and insights as part of the audit was noted. The issue was also present frequently in Phase 2b. In this phase 10 interviews discussed it. Again it is important to stress that these were ideas and insights which were being sought as part of the audit service as opposed to additional fee paying services.



In three interviews partners recognised that value could be defined in different ways and was also likely to vary over time. In two of these cases partners felt that it was the act of identifying areas where ideas and insights may be valuable that was most important.

There was a variety of areas where insights and ideas were part of the discussions. In four cases partners talked about sharing ideas or best practice from other clients or sectors and in two further cases benchmarking against other companies not necessarily in their industry. In a further case one firm facilitated making new contacts between a finance director and their peers.

In seven cases partners spoke more about providing ideas and insights into specific areas of concern to companies, including helping them to improve risk management and regulatory compliance, supporting companies on key issues or global expansion and in one case sharing ideas about cost optimisation.

Lastly under ideas and insights in two cases partners talked about training; in one case pertaining to updates for an audit committee and in another accounting updates for a finance team.

The evidence from the Phase 2b partner interviews therefore accords with that from Phase 2a which concluded that companies had expectations of the experience and talent that their perspective auditors could offer and were looking to receive the benefits of this as an integral part of their audit.

#### **6.3.5. Commercial arrangements**

In Phase 2b there were fourteen interviews which identified consideration of fees as an influence on auditor selection.

In this phase fee negotiation was also present in more interviews than other influences albeit only five compared to the eight in Phase 2a. The evidence suggests that fee negotiation can take place before the final presentation as was

evident in two cases, or after it at the end of the process, as was the case with the other three. The nature of the negotiation also varied. In one case the company sought to negotiate fees down before the final presentation using other lower quotes they had received as a threat that the issue could become critical. In another case, where negotiation took place after the presentation, there was a more specific discussion about the fee the company expected to pay and a clear indication that if that fee were offered the audit would be won. In two cases a preferred firm was invited to reduce their fee so as to close the deal. One interview identified that the firm had prepared the initial fee quotation with the expectation that the company would negotiate.

Lastly in relation to negotiation, one interview identified that it was the willingness of a firm to negotiate which was critical as it signalled a keenness to win the audit rather than the overall quantum of the fees per se.

Four interviews identified that partners felt fees were important and a further four discussed the influence of price competition in the market with instances of firms quoting much lower fees than had previously been paid. In one case an incumbent was retained with a substantially lower fee and a partner thought the fee reduction was part of justifying for the company that the tender had been a success. In another case however, the incumbent firm's existing fee was considered very low for the company of the size and complexity to that conducting the tender and the fees proposed by all the firms did not reduce.

Although therefore fees were identified as an important influence, in three cases interviews identified the audit was won by the firm with the highest fee

and in two cases partners felt that fees were not a major influence on selection decisions as long as they fell within an acceptable range or ball park. In one interview a partner explained how a company director had explained that he was looking for a fair fee for a proper job and in another, that a fee quoted by one firm was too low to be credible.

There was also discussion about the detail of the fees being proposed. In one case a procurement official sought clarification of details about the fee and elements of the service delivery and in two other cases there were also clarifications about what was included in the fee.

In one case fees were confirmed for three years and in another a partner felt that the fees quoted initially ought not to cloud the fact that an audit appointment could be for many years.

In relation to fees therefore there was evidence that they could be important to the auditor selection decision, but not in all cases. In some situations fees were less or not influential because of a focus on service, because the differentials between the fees quoted by the firms were not substantial or because negotiations prior to or after final presentations took place with the firms or at least the preferred firm to ensure that fees were acceptable after a preference made on other factors had been identified.

This concludes the consideration of Phase 2b interviews as they relate to the second higher order category service design assessment. The next section now considers interview evidence related to capabilities and competences.



## 6.4. Capabilities and competences

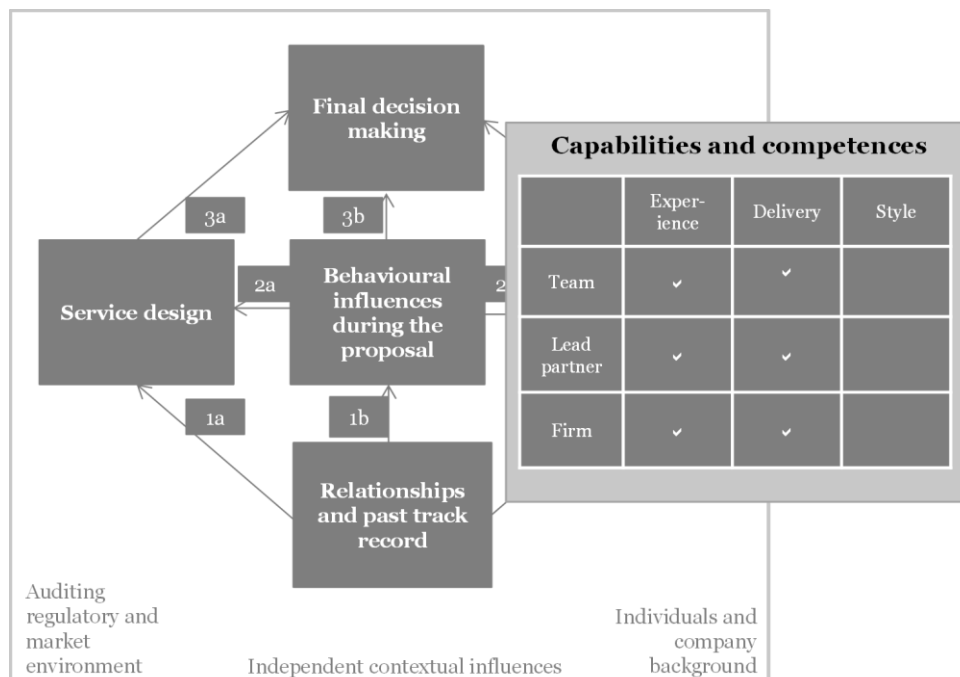


Figure 24: Phase 2b Capabilities and competences influences on auditor selection

The analysis of the Phase 2b partner interviews produced results which were consistent with the other phases with Capabilities and competences on three levels appearing to influence auditor selection. Attributes of the proposed team, the lead partner and the firm were identified by partners as influences. The number of sources and references for each subcategory are set out in Table 25 below.

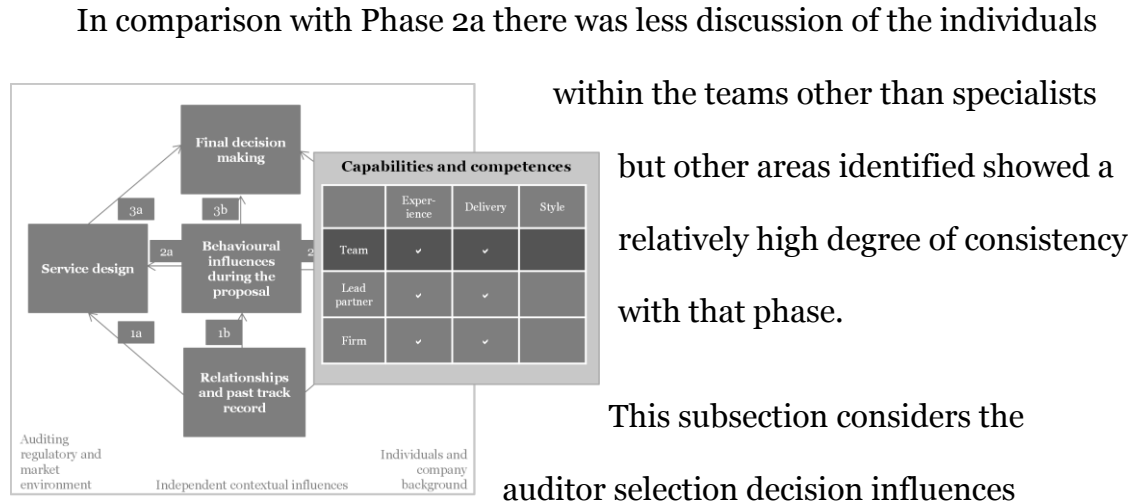
Subcategory	Sources	References
The proposed team	22	127
The lead partner	18	90
The audit firms	15	55

Table 25: Phase 2b Capabilities and competences sources and references by factor

There were again some differences in the balance of references both between and within these levels as the following sections now discuss further. In particular the partners talked far more about the team and the lead partner than

about the firm. The team, lead partner and firm considerations are dealt with in descending order of the frequency of source mentions.

6.4.1. The team



This subsection considers the auditor selection decision influences identified from the partner interviews in descending order of the frequency of discussion in relation to capabilities and competences of the teams. It covers the main headings of industry audit experience, team specialists, general strength of the team, location and geographical depth and experience of working with similar FTSE 350 companies. The matters identified in relation to the structure of the team are then also considered here.

Industry audit experience

Industry audit experience was again the most discussed element of team capabilities and competences. Thirteen interviews discussed this. The quality of the clients that team members had worked with and their ability to share the experience of what others were doing was considered important. The reassurance of credible curriculum vitae was also considered a factor.

One partner thought industry experience was especially important where there were no existing relationships. Because the team could not fall back on relationships, they were able to engage the client by discussing common industry issues and demonstrating an understanding of the business through their relevant experiences elsewhere. The influence of demonstrating understanding has been highlighted within behavioural influences and is returned to below.

In most cases relevant industry experience and expertise was present through the personal experience of the working team. In two cases however the team was augmented by including industry expertise through deep subject matter experts who were identified in the proposal process and accessible to the team and the client, although not part of the day to day audit delivery team.

### **Team specialists**

The influence of specialists as discussed by companies was considered in Section 5.4. In that section, IT specialists were most frequently identified. Although the level of discussion was less for partners, this type of specialist was again most commonly discussed as an influence on the selection decision; being talked about in seven interviews. In every case except one this related to expertise which was being offered either within the audit team or as a specialist advisor to it. This experience appeared to be especially important where it related to a key IT system or platform which the company had in operation. This seemed to provide reassurance that the audit would be appropriately tailored and that the company would obtain specialist feedback on the effective

operation of their systems; especially in relation to accounting and internal controls in operation.

In the only other case the discussion was not about expertise in a relevant system because the relevant company had a highly bespoke system. In this case the perceived positive influence was the combination of specialist IT and controls expertise and relevant experience in the industry concerned. The IT specialist's general experience in the specific industry gave reassurance that they would develop an appropriate audit approach even though they could not have experience of auditing in the company's unique IT environment.

In addition to IT specialists the partners identified a number of other specialists who had been considered influential in the decision. There were three cases where experts in relevant regulatory matters were identified and two others each which referred to industry subject matter experts (also referred to above under industry expertise) and tax specialists. Other specialists mentioned included accounting reporting, an economist and a real estate valuation expert. In two cases partners talked about the positive influence of identifying a panel of experts combining a range of the types of experiences referred to in this section.

The discussion of the role of specialists in the team is also consistent with the influence of ideas and insight identified under service design and assessment above as in most cases it was those ideas and insights that these specialists might bring which was perceived to be a positive influence.

### **General strength and experience of the team**

In 11 cases the partners talked about the influence of the team's strength and experience in more general terms. In eight of these cases partners talked about how they considered a team being strong, very strong, a great team or a really good team. In three cases this extended to partners thinking an 'A' team or a team that was the firm's best was an important influence.

In three interviews the relevant general aspect of the team was its extensive experience. Twice partners talked about "been there and done it". It was, for them, not just that people had relevant experience and expertise but that it was substantial.

### **Location and geographical depth**

The influence of the location and depth of the proposing audit teams was also again identified and there were two main issues.

Firstly where companies had their headquarters in UK regions, there was a decision to be made as to whether to locate the service team in that region or in London. The competing priorities of accessibility set against the broader FTSE 350 audit experience available in London was the principal dilemma and the positive or negative influence of either choice may well be different for different situations.

Secondly where companies had international operations, the influence was about strength and depth in key territories and also the connection between the partners who had been identified to work on the audit.

### **FTSE experience**

There was generally less discussion about experience of auditing FTSE 350 companies, perhaps because the partners interviewed had it and took it for granted. Six interviews did however discuss it. Three partners identified that a combination of industry experience and FTSE 350 (or for some companies, not necessarily those in the FTSE 100) FTSE 100 experience was important and influential. A further partner talked about how a company, even in a highly specialist industry, was interested not just in industry issues but how other major listed companies outside their industry were dealing with issues related to this group such as accounting and governance matters that might be discussed by corporate boards and/or audit committees.

Two other partners also referred to the perceived importance as they saw it of experience of working in the audit committees and board rooms of listed companies. This was referred to above in relation to the lead partner but especially in larger teams it was also identified as influential for other key partners.

### **Team structure**

For the partners interviewed during Phase 2b of the research the principal issue in relation to team structure (with only one exception) was whether the relationship was headed by one partner or two. As previously discussed the two partner model typically involved a more senior partner responsible for managing the overall relationship and a working partner responsible for the audit. The role of the two partners were however prone to confusion because

companies worried about where final accountability and responsibility rested. This appeared to be less of an issue when the senior partner also signed the accounts.

In three cases senior partners who had been proposed as relationship partners (where the more junior partner was leading the audit and signing the accounts) demonstrated that they were acutely sensitive to the issue and understood their responsibility to support the lead audit partner, but also to be clear about their responsibilities and their empowerment. In spite of this concerns still arose about who was doing what.

To some extent at least, concerns seemed to arise where the proposed structure differed from the company's past experience. Where they had been used to a two partner model and it had either worked or it had not they appeared to carry this expectation into the proposal. There were examples of both models succeeding but partners felt it was important that the companies understood how things worked and could understand and accept them especially where they differed from their past experience.

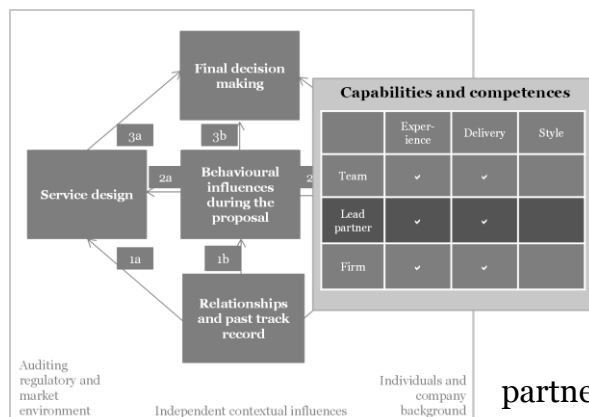
It was also important for the model to be understood at all the relevant levels of the decision making group. In one case a partner felt the team structure was well understood by the finance team, but failed because it was not understood or accepted by the finance director as the preferable option.

This section has talked about references made to teams as part of the selection decision. It has highlighted industry and segment experience, geography and team structure as selection decision influences at the team level.

The next section now considers partners comments about the influences arising from the second level of influence, namely the lead partner.

### 6.4.2. The lead partner

Overall 18 of the 24 Phase 2b interviews (75%) discussed the lead partner.



Eleven interviews discussed elements pertaining to the importance of the lead partner including six interviews which discussed the importance of the lead partner generally and four which talked

about the seriousness with which lead partner selection was considered, offering the company options from a shortlist of partners that it may choose between. In three other cases the influence of partner rotation on the whole audit relationship was discussed (NB: there was overlap with interviews having discussed more than one of these three matters).

Amongst the specific attributes about lead partners industry expertise was most frequently discussed. This was identified in 10 interviews. There were a range of issues including the benefit which came from industry experience to share what others were doing, or how they had approached certain issues. There was also discussion about lead partners' curriculum vitae which appeared to provide more general comfort that the audit partner understood how to complete the audit effectively. In a parallel case one lead partner's recent experience with one very large client in a related industry was thought



important because it affected the way that partner came across as a highly experienced and credible auditor and one who had very relevant recent experience of the types of issues that that company thought it might face. In one case a partner explained how a finance director was concerned about highly technical and regulatory topics which could only really be addressed if the lead partner had very specific experience in the relevant industry.

The lead partners' experience with FTSE listed companies was also frequently discussed. This occurred in nine instances. There was also overlap with the previous paragraph because in many cases companies were looking for listed company industry experience. Most of the discussion was generally about the importance of having this experience. In one case however a partner explained how he lost confidence when it became apparent that experience with larger listed companies was going to be important to a company which would be considering the personal reputation of the lead partner as part of their decision. Because he did not possess that experience, he felt that influenced his confidence and, as a result, his approach to and performance in the final presentation.

In addition to experience within the relevant industry and with FTSE listed companies, in four cases partners referred to the importance of the lead partner's selling skills. In two cases this related to that partners' previous proposals experience and in two cases their experience of presenting in proposals in particular.

As with the company analyses of phases 1 and 2a partners also talked not only about experience but also about the importance of a perceived ability of the lead partner to deliver the audit service.

In three cases partners felt that the competence of the lead partner was taken for granted based on the partner's previous experience, including one case where a partner thought a specific relevant competence was not tested at all. However in a larger number of other interviews, the perceived importance of a lead partner's competence delivering the audit service effectively was discussed. This took a number of different forms.

In four cases the location of the lead partner was considered important. A local partner to ensure accessibility was the influence here.

In three cases, partners thought it important that the lead partner could identify and deliver appropriate specialists to work on the audit. In two other cases, partners talked more generally about the importance of the ability of the lead partner to mobilise resources.

In two cases it was considered influential that a lead partner appeared potent in the sense that they could make decisions. Similarly in one case this was manifest in the importance of the lead partner's ability to lead their team effectively (this area is returned to below within the Behavioural influences factor group discussion under "Teamwork"). In another case it was felt important that a lead partner was actively taking responsibility for the overall audit service.

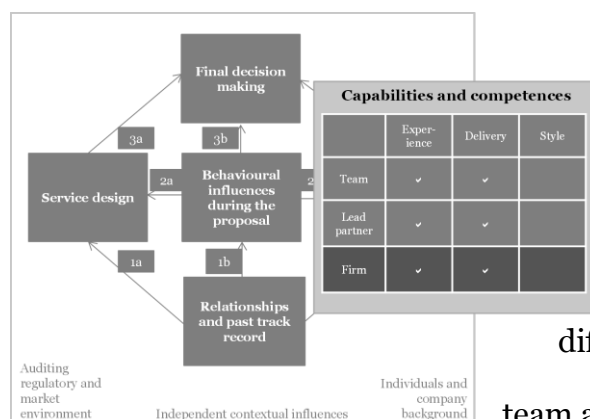
Lastly in relation to delivering the audit, in two cases partners felt there had been a concern over whether the lead partner had enough time to deliver the audit given their other commitments.

As in the other phases then the experience of the lead partner and their perceived ability to deliver the audit effectively were identified as influences on auditor selection. Phase 2b did not identify partners' personal style as an influence.

The next section now considers the third level of competence and capability assessment namely that of the firm.

### 6.4.3. The audit firms

Consistent with the other two phases the influence of comparison of firms is the third level of influence capability and competence assessment identified in



Phase 2b. Fifteen interviews

discussed this area. The balance of discussion between various aspects of this factor was however quite

different for the firm as compared to the

team and the lead partner. Whilst industry

expertise of the firms and geographical depth were still present (although much less so than in phase 2a) there was no discussion of FTSE 350 expertise at the firm level, presumably because it was another area where partners in a Big 4 firm may have considered it as assumed.

The issue of perceived conflicts and independence was however more prevalent than in Phase 2a and was discussed in 12 of the interviews. Before considering industry expertise and geographic depth influences on auditor selection at the firm level, conflicts and independence are therefore considered first.

### **Perceived conflicts and independence**

The partners felt that the main issue as it related to perceived conflicts of interest and independence was in relation to becoming the auditor and managing other non-audit relationships.

Three partners talked generally about the challenge posed of meeting independence requirements where their firm provided non-audit services. Three others talked about the challenge of becoming external auditor when already providing outsourced internal audit services and in another case the potential conflict was with the small, but high profile area, of advising the board on remuneration.

For one partner the issue was one of public perception caused by the disclosure in the companies' annual reports of both audit fees and non-audit fees paid to the auditor. Where the non-audit fees were high they attracted pressure group attention.

In one case a firm had declined to bid on the basis that their non-audit services were so substantial, although in the same case, another firm had been strongly encouraged to (and did) bid even though the audit fee was lower than

the non-audit fees they were currently receiving. The company indicated or at least implied that a no bid decision may have put future service relations at risk anyway.

### **Industry expertise of the firms**

Industry experience was identified in Phase 2a and in Phase 1 as a frequently commented on factor in auditor selection and the balance of comment was substantially in favour of it being a positive influence. In Phase 2b however there was far less comment on this topic and it arose in only six interviews. In addition there was more balance as to whether industry experience at the firm level (as opposed to the team or lead partner) was a positive influence.

Three interviews did identify the benefits of industry experience at a firm level. These included the firm supporting the team, the advantages of audit and non-audit service providers within a firm collaborating, and the potential benefits of market share and of marketing efforts. One partner also talked about the negative influence of one of the competitor firms in a proposal not having industry experience in depth around the world. Only one less interview however discussed the negative influence of auditing competitors in the same industry. As referenced previously this is consistent with the literature which argues that market concentration is discouraged by competitors in the same industry not wanting the same auditor (Kwon, 1996).

In one case a partner felt industry expertise would be claimed by all of the firms and would therefore not be influential.

### **Local strength in depth in key UK and overseas locations**

There was relatively less discussion in the partner interviews about local strength in depth and the matter arose in only five interviews. In two of these cases, the importance related to strength in depth in specific territories in, one other the requirement was for broader capability to respond to an expanding company's needs internationally for the future.

In one case the discussion was about whether a UK regional office had sufficient expertise to support a specific company at the Group level.

This concludes the discussion of the findings from Phase 2b as they related to the influence of capabilities and competences on the auditor selection. Phase 2b again found capabilities and competences of the competing bidders was being assessed at three levels; the team, the lead partner and the firm, and across industry, technical and geographical requirements. The next section now considers the next identified higher order category namely Behavioural influences during the proposal process.

### **6.5. Behavioural influences during the proposal process**

The two previous phases had identified behavioural influences affecting auditor selection. This had been identified in each of the 23 interviews in Phase 2a. Phase 2b also identified these behavioural influences. Indeed they were discussed in each of the 24 interviews conducted as part of this phase.

Moreover the frequency of mention within those interviews was also high. Phase 2a had identified a much richer discussion in terms of number of

references per source than Phase 1 (accepting the previously identified limitations of that phase). Phase 2b however appeared even more focussed on behavioural influences. As well as being identified in all 24 interviews there were 608 references. This was almost twice the next highest referenced factor past Relationships and past track record. This is discussed further in Chapter 7.

Within this behavioural group the nodes created in initial coding again fell quite naturally into the four consolidated groups drawn out in Phase 2a namely: Testing and Proving, Caring, Quality of Interaction and Quality of Response.

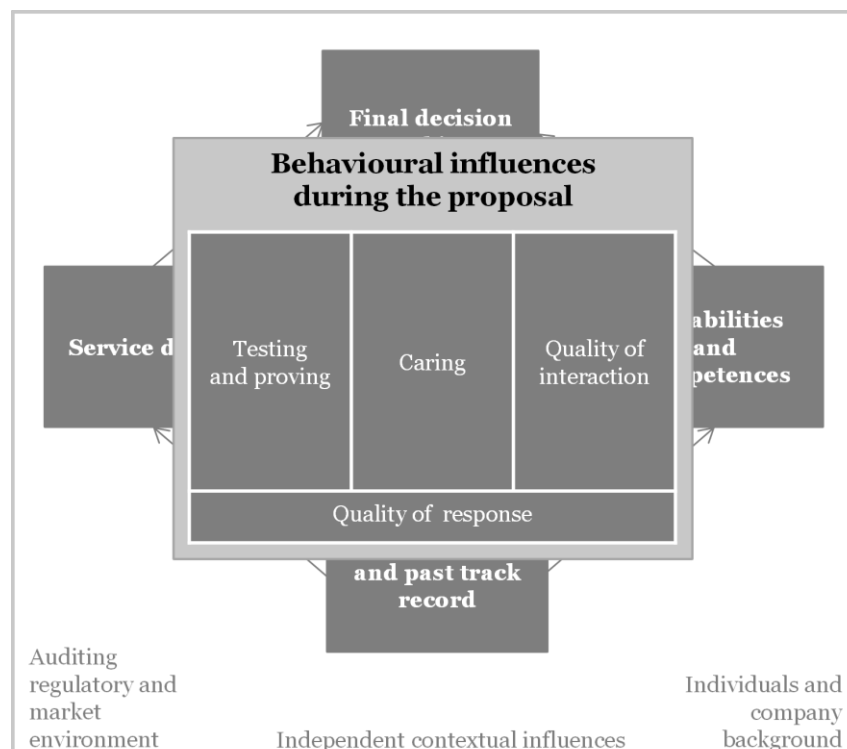


Figure 25: Behavioural influences on auditor selection

The frequency of mention of the Quality of the interaction and that of Testing and proving ideas was in particular very high relative to the others.

The next part of this chapter concerns itself with the Phase 2b behavioural influence findings. The number of source interviews and references identified

through coding and analysis from Phase 2b are set out in Table 26 and discussed further below.

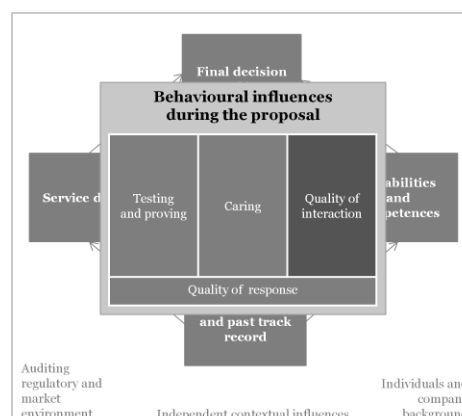
Subcategory	Sources	References
<b>Quality of interaction</b>	<b>24</b>	<b>212</b>
Connection and engagement	24	166
Teamwork	17	47
<b>Testing and proving</b>	<b>24</b>	<b>194</b>
Testing ideas and proving ideas and propositions	24	137
Proving competence and capability	19	57
<b>Caring</b>	<b>23</b>	<b>144</b>
Hunger, energy and commitment	18	67
Listening and understanding	17	78
<b>The quality of response</b>	<b>20</b>	<b>58</b>

Table 26: Phase 2b sources and references for Behavioural influences

The consideration of four subcategories is conducted in descending order in terms of the number of source interviews in which the topics were raised. This therefore starts with Quality of interaction.

### 6.5.1. Quality of interaction

The most frequently referenced behavioural influence from Phase 2b related to the general quality of the interaction that took place during the proposal process. This had two dimensions: the interaction between the company and the audit teams (which is considered below under the heading Connection and engagement) and the teamwork that the audit teams demonstrated.





## **Connection and engagement**

The partner interviews provided a rich picture of the level and nature of interaction that took place in the proposals that they were involved in. All of the interviews discussed this and there were 166 references to it. The interview analysis provided evidence of the influence of personal connection and that of the nature of interaction. These are now considered in turn.

### **Personal connection**

In total, 19 interviews discussed factors related to personal connection. This was manifest in comments concerning the partners' views on relationship development as the purpose of meetings, the warmth or otherwise of meetings, the presence or absence of liking, the importance of authenticity and of personal chemistry and other related comments.

In terms of the purpose of meetings, eight partners talked about meetings or the importance of meetings during a proposal process as relationship building activities or as opportunities to get to know the individuals at the company. In some cases some of the proposing team knew those at the company, while others did not so the meetings were about building relationships across the team with the company.

One partner expressed it as:

*If we filmed it you would have seen a bunch of people getting to know each other, learning about each other...Having a discussion about things that*

*mattered and you know it didn't need to be [tendering company], it could be any business you like in that first meeting"*

Six interviews talked about it being important that people at the tendering companies liked individuals on the team. One partner expressed that he thought liking was critical:

*"If they didn't like the lead partner and they didn't have a mechanism to change that lead partner I don't think you'd get the job"*

Six interviews also talked about whether meetings were warm or not. Partners were positive about warm meetings and concerned when they did not get this sense of warmth, in particular had the person they met had a warm meeting with someone else?

Where there was liking or warmth, partners felt the discussions became more open and partners felt they were able to focus on clarifying areas of the proposition more effectively.

Five interviewees talked about how important they thought it was to be authentic and consistent throughout a proposal process. Four of these interviews talked about partners "being ourselves" as an important part of the proposal interaction with the company and "not trying to be something you aren't". Two further interviews talked about the importance of displaying consistent behaviour during the proposal.

Three interviews spoke specifically about "chemistry". Whilst accepting the influence of prior relationships, one partner thought it was also important to

establish personal chemistry during the process by investing time and making an impact. Another partner talked about the importance of establishing personal chemistry with people across a company. The third talked of his concerns when there appeared to be no chemistry between the lead partner and the company's finance director even though they were of similar backgrounds and had common industry knowledge.

Other interviews talked about “engaging”, “gelling” and “attachment”. Evidence of interest in individuals as people was also provided by one interview which identified an audit committee chair asking the junior team members about their personal backgrounds and interests in the final presentation.

### **Dynamics of the proposal interaction**

As well as comments concerning personal connection, there was considerable evidence of partners considering the influence of the dynamics of interaction during the proposal process. This interaction occurred in the meetings that took place within the proposal process and in the final presentations. There was also evidence of the influence other meetings taking place during the proposal period but outside the proposal process.

In total 18 interviews talked about the dynamics of the interactions that took place during the proposal process in meetings and the final presentation or presentations and a further six about interactions outside the process but concurrent with it.

In terms of meetings the most important theme was the importance that partners attached to informality and discussion. Informal discussions were talked about positively and arose in a number of different but similar discussions. There were four interviews that talked specifically about informality and four others which talked positively about meetings as a discussion. A further two referred to meetings as a working session. One partner described the meetings as “*grown-ups having a chat*”. For him the meetings when effective were informal discussions but about the important issues at hand.

The importance of meetings as discussions could be increased further depending on a company’s culture. Where companies tended themselves to be informal and resolve issues through discussion, it could become especially influential for the firms to take a similar approach. The following quote from one partner illustrates this:

*“You know we had all these beautiful cardboard stuff produced [meetings support materials], all our pictures in and didn’t even get looked at. They just didn’t want that style of process. They wanted to sit down and talk and communicate. .. That’s just how they are. .. Get your heads together, talk about it, sort it, go and deal with it. I think there’s an element of luck that the [Firm’s] team was composed as it was and that just fitted straight in”*

In addition to informality and discussion, partners also commented on other specific meetings dynamics. In three of the interviews partners talked about where people sat. By avoiding taking positions on opposite sides of the

table it was felt that formality was reduced and a more constructive discussion resulted. A further three interviews talked about the use of technology as a facilitator for collaboration in agreeing ideas and approaches with the companies (even when initially it went wrong). In two interviews partners talked about the importance for them of achieving a reasonable balance of talking between the company and the firm's team.

Six interviews touched on contact outside the scheduled proposal meetings. Where this occurred it was seen positively, providing further chances to interact and also to obtain views of those on the periphery of the proposal process. In one case this involved regular but informal discussions with the Chief Executive of a company who had not been scheduled to be involved in the process. This case involved a re-proposal for the partner of an existing client where he had a positive relationship with the Chief Executive concerned (NB: there can be potential sensitivity about respecting and complying with companies' prescribed proposal process as previously discussed and this is returned to in Section 6.5.4 where the impact of breaking the rules is touched upon).

The contact around the proposal process could arise through providing the audit or other services, through other impromptu meetings and, on two occasions, just as a result of teams arriving early for scheduled meetings and getting involved in discussions before the meetings formally commenced. There was only one reference to direct social contact outside any process elements between those directly involved in the proposal process and decision makers

during a proposal, perhaps suggesting partners thought that this was outside the bounds of what was acceptable.

There was however one example where a company specifically built an element of social interaction into the process to provide an opportunity for the senior teams and the firms to get to know each other. In this case a dinner was held with each of the competing firms and was formally assessed as part of the overall proposal evaluation.

There was also evidence that partners thought discussion and informality in final presentations was also a positive influence on the selection process although the actual dynamic in those final presentations appeared to be quite varied. Whilst some were open and discursive others were more formal involving less interaction.

Ten interviews discussed the dynamic of interaction in relation to the final presentations. Whilst in four cases partners again expressed their desire to convert the presentations into a discussion or conversation, in practice there was a range of dynamics. In three cases there was open dialogue and discussion including one case where the panel actively guided the presentation to the areas of interest and away from other areas. However in three other cases partners described formal processes with a presentation followed by pre-prepared questions. In two of these cases they described the audience as cold or “stand offish”. Formality was in each case seen to be a negative influence on their perception of the selection decision. In other words partners felt that less formal discussion was normally more likely to lead to a successful outcome for them.

There were also instances of presentations which fell somewhere in the middle in terms of dynamics with firms presenting for part of the session largely uninterrupted, followed by open and interactive question and answer sessions.

In four cases, in otherwise formal proceedings, partners talked in positive terms about the role of humour in supporting better interaction.

The variety in the dynamics of the final presentations was also influenced by the behaviour of the panels. In one case a team was told they had ten minutes to put their case, in another an Audit Committee Chair appeared to rant about a particular issue of concern to him, whilst another Audit Committee Chair was observed almost to have fallen asleep in the presentation.

In spite of the variety of practical dynamics the overall theme from the partner interviews in this area was that the nature of the interaction in this final presentation was important (as well as the content of the presentation and question and answer session which will be returned to below) and that conversation and dialogue was a positive influence on the selection process.

This section has considered the dynamic of the interaction which was seen to take place in the proposal process between audit teams proposing the company personnel involved in the auditor selection process. The nature of interaction between the audit team members was however, again considered important and is now discussed under “Teamwork”.

## **Teamwork**

The influence of teamwork on the auditor selection decision was discussed in 17 of the interviews, which was a much higher proportion of the total than in Phase 2a. The analysis identified two influences within this group which were the important role of the lead partner in leading the team and the effective interaction between team members.

There were 14 interviews which highlighted leadership as an influence and the underlying comments identified a number of different manifestations of its importance. In three interviews, partners talked about the importance of leadership generally to the team and in two others similarly about the importance of the lead partner to the effective operation of that team. In two cases partners talked about the importance of the lead partner empowering the team to the extent that that person did not need to be at a number of the proposal meetings and local divisional partners were able to be seen leading their teams. Conversely where the lead partner was present, in two cases, people talked about the importance of meetings being effectively led by the lead partner. In three cases partners talked about the need to demonstrate global cohesion across the international team and the important roles of the lead partner being seen to make that happen. In one further case, a partner talked about how all communication with a company during a proposal was controlled by the lead partner.

In terms of teamwork more generally, ten interviews were highlighted and in six of these instances partners felt it important that the key people on the



team knew each other before the proposal and in five cases that people had worked together before. In three other cases it was important that partners got to know each other during the proposal and twice that it was important that teams spent time together. Three further interviews talked about personal chemistry between members of the team and three others about the importance of relationships within the team.

It is therefore clear that in these cases partners thought teamwork to be important. There is less evidence to support what they thought the impact was on the company. It may have been indirect in the sense that good teamwork supported other positive influences, although in three cases partners did talk about the importance they saw in coming across as a team.

#### **6.5.2. Testing and proving**

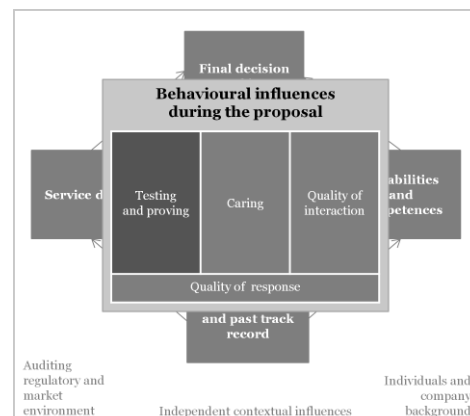
After discussion of the general quality of interaction which took place during a proposal process, the second area of behavioural influence identified related to the testing and proving activities which took place during the process. This again had two elements: the companies testing the firms' and their propositions (and those firms seeking to prove themselves and their ideas) and the firms testing their ideas and attempting to prove their propositions.

Companies assessing teams and their propositions is considered first.

## **Testing and proving ideas and propositions**

There was considerable discussion in the partner interviews about them testing ideas and propositions. Very consistent with the ideas of Service Dominant Logic (Vargo and Lusch, 2004) and discussed in Chapter 2 there was a high level of discussion about partners testing their ideas, receiving and responding to feedback and actively seeking feedback and confirmation of their teams and ideas. As returned to below, this commonly included the involvement of senior partners of their firm outside the proposal team. This area was discussed in all 24 interviews and the reference count was also high at 137.

In 21 cases partners talked about evolving and developing their service propositions and tailoring them to the specific circumstances of the company. Within this group four interviews discussed the meetings purpose as information gathering to enable the firms to prepare their proposals and in a further 12 interviews discussed how the firm's proposition was developed and evolved during the proposal process.



In some cases there was more than one meeting. In these cases the first meeting focussed on finding out what the company wanted, perhaps organised around themes or topics and suggesting ideas and the second became focussed on testing the proposition and refining it.

Also within this group of interviews, there was evidence of the firm co-developing the proposition using prepared charts or technology. The discussions covered the overall nature of the audit relationship and not just the core audit service (so including the facilitating and supporting services discussed in Section 6.3.3 and 6.3.4.). Firms were also testing the structure of the proposed team and exploring solutions to problems identified by companies. The interviews identified examples of approaches and ideas being confirmed and changes where the company felt things may be missing or not quite right.

In addition to the scheduled proposal meetings 11 partners also talked about the feedback they got during the process outside these formal meetings. In some cases this was limited because of the culture within the tendering company however in others very specific feedback was given. In one case this was organised as a formal part of the process although in most cases it was based on relationships which pre-existed the proposal.

The important role of a coach within the company being proposed to was also discussed in 11 interviews and within this, the role played by alumni as coach was identified in four interviews. This was previously highlighted in Section 6.2.3.

What was fed back also appeared to vary from specific comment on aspects of the approach and the firm's performance during meetings, to more general comments about the team's performance relative to its competition. Most commonly however the feedback was in relation to individual members of the team. This arose either to confirm that individuals appeared to fit the

organisation being tendered for or not. Five interviews identified that there had been changes in the proposed teams which resulted from feedback being received and acted on by the firm.

Feedback also appears to have influenced behaviour. For example in three interviews the motivating influence of getting positive feedback early in the process was identified.

The firms also sought independent feedback using senior partners outside the proposed delivery team to check in on progress and performance and whether the individuals in the team appeared to be the best fit for the company. This kind of independent checking was mentioned in six of the interviews.

The interviews including references to proposition development and obtaining and responding to feedback (so testing and adapting the proposition) substantially outnumbered those which talked merely about explaining and communicating the proposition, although 10 interviews did discuss the partners' views that clarity was important in communicating their propositions. A need for clarity was identified in the context of meetings (six instances) and specifically responding clearly to questions and concerns by explaining aspects of the approach (as opposed to responding by adapting as discussed above). Clarification normally took place in the meetings during the process although in one case a partner talked about this taking place in the final proposal document.

In four cases partners talked about supporting the clear communication of their proposals using examples and stories or relevant examples to demonstrate the points they were making.

Lastly concerning testing and proving ideas and propositions, seven partners talked about the importance of consistent messages, in three cases expressing frustration that they did not arrive at the messages they wanted to deliver until too late in the process. One partner acknowledged the difficulty in delivering consistent messages during a proposal process when the necessary collaboration to arrive at the right answer for the company was taking place alongside.

### **Testing and proving capability and competence**

As well as partners highlighting the importance they attached to testing their ideas and propositions, the phase 2b interviews also showed that they considered the selection process to involve them proving and being tested themselves by the tendering companies. This can be broken down into two different themes. Firstly partners' comments in relation to demonstrating competence and capabilities during the proposal process and secondly what they said about how the companies that they proposed for tested that competence and their final propositions. Each is now considered below.

Capabilities and competences is of course one of the factor groups influencing auditor selection as discussed in Section 6.3 and in earlier phases. This section reflects that that is not a static assessment but rather is also influenced by behaviour during the proposal process.

## **Firms supporting competence and capabilities**

The partners talked about demonstrating their competence and capability in support of auditor selection in 14 interviews. In seven of those interviews the discussion concerned showing credentials of individuals and the team in the proposal meetings. In three of these cases it was about partners feeling it was important for the team to demonstrate relevant industry credentials. In three others the focus was on the credentials of specialists including systems, treasury and actuarial. In two other cases partners talked about demonstrating the credentials of key individuals at the presentation and specifically overseas partners who may not have met the company's head office management and audit committee members and who therefore were using the final presentation to demonstrate their competence.

Four interviews discussed the influence partners considered from generally communicating the strength of the team in meetings, playing to their strengths and showing they could do a good job.

There was only one case where a partner thought a key part of the proposal was communicating the strength of the firm (as opposed to individuals or the team) in a particular proposal. In this case the issue was about persuading a company of the firm's credentials in an industry where before the proposal that company considered another Big 4 firm to be pre-eminent.

## **Companies testing firms and their propositions**

Consistent with Phase 2a most of the discussion about companies assessing competence and testing the teams and their propositions was discussed in relation to the final presentation. In total 12 interviews discussed companies testing teams and exploring their propositions and in ten of these cases partners referred to what went on in the final presentation.

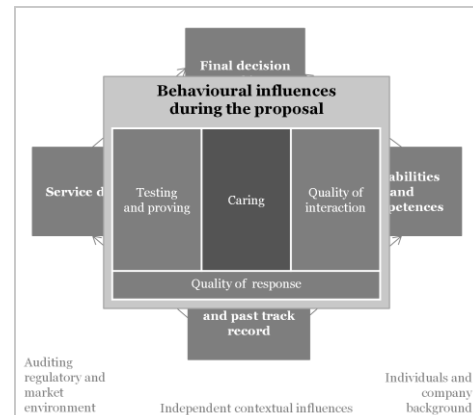
In each of these 12 cases, partners talked about thorough questioning during that presentation. The questioning tended to be orchestrated and led by the Audit Committee Chair; and partners thought the questions were specific to their proposal rather than formulaic. The questions asked included those which sought elaboration on what was said as well as probing on certain areas related to the service proposals including: audit approach to specific areas, approach to auditor independence, approach to audit transition and testing their value propositions.

In spite of what were, at least *prima facie*, question sessions there were two examples where partners thought they were just completing the process and were not really influencing the decision. The implication being that the decision had already been taken at least in most part before the presentation took place.

Four interviews also talked about partners' experience and their proposals being tested in meetings during the process. From the interviews it is unclear as to whether this was because these testing conversations were not taking place or because partners recalled the presentations as being more important or just because they were more recent and or formal.

### 6.5.3. Caring

The third type of the behavioural influence from Phase 2b, Caring includes those comments which demonstrated to companies that the firms wanted to win the audit and were keen to understand what would be really important and respond to what they heard.



Consistent with Phase 2a this is now considered starting with the influence of firms demonstrating hunger, energy, enthusiasm and commitment.

### **Hunger, enthusiasm, energy and commitment**

The Phase 2b interviews again identified influences relevant to the hunger, enthusiasm, energy and commitment demonstrated by the firms. In this phase there were four themes: firstly the amount of time and effort that the firms were seen to have invested in the proposal process, secondly the energy and enthusiasm that was exhibited within the interactions which took place in and around the process, thirdly the role played by the most senior partners of the competing firms and lastly the overall objective in this area being seen to be making the client feel important.

The time and effort invested by firms in the process was mentioned in 10 interviews and in half of these specifically in the context of the time seen to be spent by the lead partner. In one case a lead partner was described in relation to



one company as “*almost living in their offices*”. In another case a partner talked about the negative influence from his perspective on the selection decision of being constrained by the formal process from making sufficient contact. In five cases partners also talked about going beyond the proposal process and producing additional outputs first and foremost to show the effort that they were putting in. This included video material, dedicated websites and presentational approaches including professionally produced caricatures.

Energy and enthusiasm was raised in seven interviews. Partners talked about their perceptions of a positive influence of demonstrating energy, enthusiasm and in two cases passion to win the work. One partner thought it had been important that the team had demonstrated to the company that in terms of the audit they “*wanted it more*”.

Also in seven cases partners talked about the role of senior partners within their firms who were not part of the proposed day to day service team but who were involved through meetings or calls to try to demonstrate the commitment of the firm to the proposal process. The impact in practice appears to have been mixed. Whilst some partners thought it helpful to supplement their own efforts in this way and in one case a critical issue was resolved by the chairman of the firm, in another case a partner talked about a firm involving very senior partners outside the service team in a number of meetings to the detriment of their proposal because the company personnel wanted to meet the people that they would be working with going forward.

In four cases partners talked about how they felt it was important to make the company feel an important client and in one case the most important client. This related to both the importance of the client to the proposing team as individuals and to the firm as a whole.

### **Listening and demonstrating understanding**

Lastly under “Caring” there was also evidence of the influence of the demonstration of listening and understanding on the selection decision. There were 17 interviews which commented on this.

Within understanding partners talked most commonly about the importance of the company seeing that they understood the business (which was mentioned in six interviews) and related to that, five interviews talked about the perceived importance of understanding the company.

The way that business understanding was addressed ranged from partners taking prepared materials which set out their understanding of the business, and in one case specifically its strategy, to discussion which focussed on issues relevant to the business. Partners felt it important to share their perspectives on relevant issues as they impacted the company and its market. They also thought it important that they could demonstrate that they understood the industry context. This of course supports the focus on industry expertise and experience highlighted under competency and capability above. In one case it was felt that a company was very proud of its business and it was important in that case to understand and respect the pride that the management team had in it.

There were nine interviews which talked about listening. The focus for the partners was however slightly different from those expressed by the companies in Phase 2a. Whilst most of the comments made by companies related to valuing being listened to, the partners talked about listening in the sense of what it enabled them to do. Most of the Phase 2b interviews talked about listening being important because it enabled them to understand the company and to develop responses which were relevant to it. So whilst for companies listening was about being listened to, for the partners it was less the act of listening that was important rather it was what else it enabled them to do.

#### 6.5.4. Quality of response

The partners recognised the importance of completing the tender professionally, and for them this was demonstrated in the quality of the tender document, the presentation and in the approach to and performance in the meetings which led up to it.



In 11 cases partners talked about the quality of the documents submitted. Their comments were quite general and normally about whether they thought the documents that they had submitted were of high quality. Twice, however, partners mentioned that they thought they had spent too much time in document preparation. Two partners also noted the importance of completing a

good document so as not to lose the proposal although they doubted that such a good document could ensure that a proposal was won.

Nine interviews discussed the conduct of the meetings that took place during the process. In seven cases the preparation of an appropriate or tailored agenda was discussed. In three cases partners talked about how they rehearsed for meetings. Two partners talked about the need to appear prepared and in a further case a partner talked about professionalising meetings.

In seven cases partners talked about the general quality of the final presentation that they had delivered, although in one of these cases the partner had had feedback from the target company that all of the firms had completed high quality presentations.

Four interviews discussed the effect of firms breaking the rules of the tender. In one case a partner mentioned that a finance director had told him that all of the competing firms had irritated him at some stage during the process by not following the rules. Conversely two partners talked about the apparent advantage achieved by breaking the rules. In the first case this involved additional ad hoc meetings with a company's chief executive who was not supposed to be involved in the process. In the second additional information had been provided by the firm in its tender submission beyond the prescribed limits set out in the invitation to tender. Although the client appeared irritated, the material had addressed an area of potential concern and was therefore thought overall to be at least neutral in its influence.

The findings here in relation to companies' attitudes to breaking the rules appear consistent with the other phases. A certain degree of rule breaking is accepted if it is seen as a signal of the relevant firm's eagerness and enthusiasm to win the appointment.

Finally partners also talked about how they felt it important to be organised and professional generally throughout the proposal process as a whole and one partner talked about respecting the company.

## 6.6. Final decision making

The final factor group influencing auditor selection by FTSE 350 companies and included in the conceptual model as in the previous phases relates to the Final

decision making. In Phase 2b there was relatively less comment about which elements of the process were considered influential. Instead partners talked more about how they saw what was going on (including as has been outlined above a lot of focus on behavioural

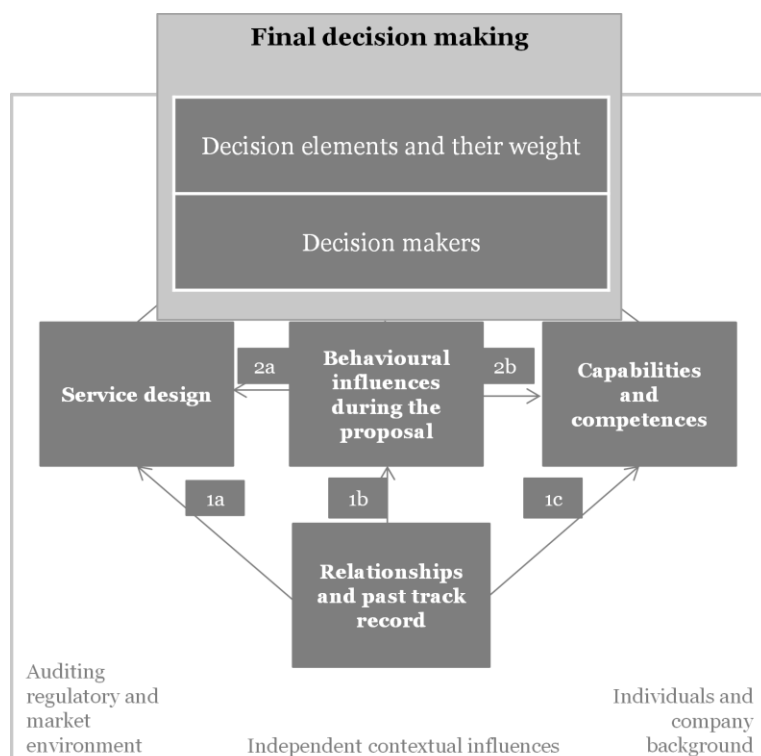


Figure 26: Phase 2b Final decision making influences on auditor selection

interaction) rather than about the relative influences of any stage.

Partners would not have seen the discussion that resulted in the final decision and so this is not considered in this phase. There was some more limited comments on the various stages and the decision makers.

Consistent with the buyer side view highlighted in the previous chapters, the partners thought that companies had invested time and effort to run a fair and proper process. The time invested in the process was evidenced by partners talking about processes being extensive (five instances), intense (three instances) or rigorous (one instance). However processes were also seen to be fair or a level playing field (four instances) and well managed and controlled. Partners identified access being controlled (four instances) and of processes being professional (two instances). There was also reference to companies seeking advice from the firms on how to run the process, having a dedicated project manager and, in one case, appointing an external consultant to oversee the process for them.

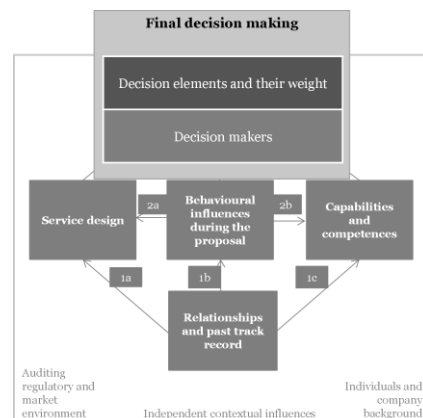
As noted above, because partners were not included in the final decision deliberations, this was not discussed, however views, albeit with lesser references, were expressed on the importance of the various elements of the decision and those involved. The numbers of sources and references for each of these areas is set out in Table 27 and then considered in turn.

Subcategory	Sources	References
The decision elements and their weight	18	49
Engagement and connection	16	33

Table 27: Phase 2b sources and references for Final decision making

### 6.6.1. The decision elements and their weight

Partners talked about the relative importance of the meetings (ten instances) and presentations (eight instances) that took place during the proposal process, and to a lesser extent the importance of the documents submitted (four instances).



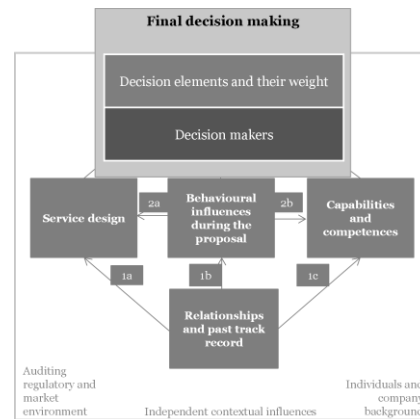
The meetings were explicitly identified as important (four instances) and interestingly the partners saw them as an important part of creating momentum (three instances). Partners also thought them important as selection influencers would be talking to each other and sharing views (two instances).

Discussion about whether presentations were important or not took place in ten interviews. In eight cases partners thought the presentations were important; normally because they thought the proposal decision was close up until that point or because certain critical issues were resolved in the final presentation meeting. In four cases however partners thought the decision had already been made before the final presentation and, in four others, partners were unsure as to whether the presentation was important or not because of the behaviour of the selection panel (appearing disinterested or overly formal).

There was variable comment about the importance of the proposal document. Across the five interviews which highlighted it, partners felt it was important not produce a poor document although they did not feel it was otherwise important to the final decision.

### 6.6.2. Decision makers

The partners made observations about who they thought was making the decision based on their knowledge of the companies and on the way that the selection panel behaved during the final presentation and question and answer session (16 instances).



The partners observed the Audit Committee Chairs chairing the meetings and in some cases strongly, appearing to be controlling and overseeing the process. They also however recognised the strong influence of the Finance Director and in, two instances, the Chief Executive who was described as in the background but nevertheless influential (in one case being seen as decisive).

An interesting insight was offered by one partner who felt the person managing the process was in a powerful position as they would be receiving and interpreting the feedback from the various meetings and could decide what they thought was important for the main decision makers to focus on.



## **6.7. Relationships between the factor groups**

Phase 2b again highlighted connections between the main decision influence factor groups.

### **The influence of past relationships and track record on other factors groups**

In Section 6.2.1 it was highlighted that partners used the problems companies expressed in relation to their incumbent auditors to help shape their own services propositions. Section 6.2.2 also identified the important influence of previous service relationships and targeting in providing invaluable knowledge and understanding to shape Service design. This section also talked about the problems where this was not in place and the assumptions that otherwise needed to be made; introducing the risk of making mistakes in service design.

Also in Section 6.2.2 the influence of past service problems on the behavioural interactions that took place during a proposal process was identified. The past services problems were observed to dominate the conversations and reinforce the company's feeling of dissatisfaction. Conversely, (as referenced in Section 6.2.2), past positive relationships in non-audit services and targeting made meetings easier; with those with existing relationships facilitating the introduction of new members of the team.

Lastly in concerning past relationships, past service experience had created expectations about capabilities and competences.

### **The influence of behaviour during a proposal process on service design and capability and competence assessment**

Section 6.5 highlighted the testing and proving activities that partners observed during proposal processes. Behaviour during a proposal process was seen to include teams testing and proving their ideas and so helping to develop their service design proposals. There was evidence of a number of changes being made during the process to the plans being developed.

The proposal process was also seen to include firms putting forward their credentials and companies testing the capabilities and competences of the teams. Commonly using senior partners “independent” of the proposing teams, feedback was received which led to changes in members of the team and confirmed the companies’ views about the capabilities and competences being presented.

### **The influence of Service design, behaviour during the process and Capabilities and competences assessment on Final decision making**

The three phases have confirmed the same five factor groups affecting the selection of auditors by FTSE 350 companies which culminate in Final decision making influenced by Service design, capability and competence and behavioural factor groups.

In addition to the influence of behaviour on Service design and Capabilities and competences, it also influences Decision making directly

through the more affective influences of personal interaction and demonstrating that competing firms care .

## 6.8. Summary and conclusion on Phase 2b

This chapter has set out the findings of Phase 2b of the current research which involved 24 in-depth interviews with partners of a Big 4 firm who had recently been involved in an auditor selection decision. This analysis was conducted in accordance with the approach set out in Section 3.2.4 above and although Phase 2b used the same grounded approach as in the other two phases it supported the conceptual model which was developed in Phase 2a and is reproduced below.

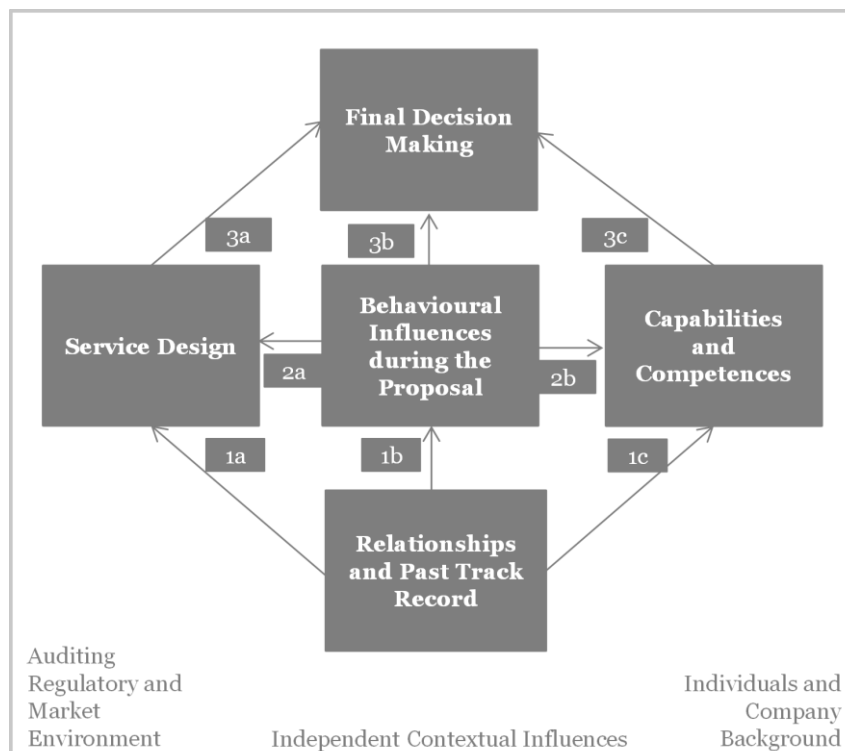


Figure 27: The revised conceptual model

The partners focussed especially on behavioural influences. Service design was discussed relatively less.

### **Relationships and track record**

Phase 2b of the current research supported the presence of influences on auditor selection arising from the relationship that companies had with the firms and the service track record they had experienced.

There was a high occurrence of audit proposals taking place against a background of services problems with incumbent auditors. In addition incumbent auditors faced inherent threats to their position from changes in key management. Levels of change within an organisation could also pose a threat to the incumbent although in other cases companies' concerns over the level of disruption favoured them. Transition of auditor was identified as a concern but the non-incumbent firms developed detailed transition plans to help mitigate this concern.

Firms used their non-audit service relationships and targeting efforts to build knowledge of companies and relationships with their people which helped them to tailor their proposals more accurately.

Where those on auditor selection panels had past working relationships with an audit firm these could be critical to the selection decision especially if the same individuals are involved.

Alumni were seen to be important as coaches to their former employers.

Trust was considered important by the partners; past behaviour being seen as important to consideration of the future service relationships.

There was little evidence of the influence of cross-directorships and similarly little discussion concerning references.

### **Service design**

Although the level of discussion of service design was low compared to the other two phases of the research it was possible again to organise the consideration of the discussion in this area using the same model as Phase 2a. This included the core audit which was associated with rigour and assurance. The facilitating services which were discussed were again working relationship, coordination and communication associated with the audit, accounting technical matters (especially dealing with accounting issues), the approach to the audit of IT systems and controls and how auditors proposed to work with internal audit departments.

Partners thought companies were also again looking for ideas and insights from their auditors based on their broader knowledge and experience

The partners thought fees were an important consideration although the lowest fee was not always successful. A particular focus of the partner discussions was the negotiation that took place around fees. This could happen after receipt of proposal documents but before the presentation or in or after the presentation.

### **Capabilities and competences**

Three main levels of capabilities and competence assessment were again present namely the team, the lead partner and the firm.

For the team partners felt industry and FTSE 350 experience and geographical strength in depth were important. The important role of specialists; especially IT audit specialists was also highlighted.

Partners also thought the structure of the team especially the leadership of the team important. The key decision was whether to lead the team with a single partner or two working together.

The lead partner's industry and FTSE experience was also considered an influence on auditor selection. In addition to their experience the lead partner's ability to deliver the firm and their personal styles were also discussed.

For the firm a particular focus for the partners was managing conflicts with other services and independence.

### **Behavioural influences**

Behavioural influences were by far the most discussed influence arising from Phase 2b.

The partners felt that the quality of interaction that went on in the meetings and final presentation was particularly important. This included establishing a personal connection or chemistry. It was felt informality and discussion were critical.

There was also testing and proving people and their ideas. Whilst the partners were testing their ideas and their teams and adapting and changing in response to what they heard, companies were testing the competence of the teams; especially in the final presentation.

Phase 2b again identified the influence of firms showing companies that they wanted the audit and cared about the service to be delivered. This was manifest in the enthusiasm, energy and commitment that the firms demonstrated and also in their listening and in particular responding to what they were told.

Lastly the partners felt it was important to respond to the tender in a high quality and professional way.

### **Final decision making**

There was much less reference to the final decision during Phase 2b. This was consistent with the fact that the partners would not have seen the final decision discussion.

Partners did however feel that the meetings were important as they created momentum for the final decision. They also recognised the dynamic of formal audit committee responsibility but the influential role of the finance director and on occasion the chief executive.

### **Relationships between the factor groups**

Phase 2b again highlighted some interesting connections between the main decision influence groups.

The past track record appeared to influence service design. This was especially in responding to service problems. The past service experience at other companies or of non-audit services and targeting activity at the company concerned seemed to influence assessments of the future working relationship

and capabilities. In addition past behaviour was seen as an indication of likely future behaviour.

Behavioural influences affected service design. Firms evolved their propositions by testing their ideas and listening and responding to what was told to them. Companies tested capabilities and competences especially in the final presentation.

That concludes consideration of findings in Phase 2b which was the third and final stage of the analysis. The next chapter now discusses the findings across all three phases.



## CHAPTER SEVEN

### DISCUSSION AND CONCLUSION

#### 7.0. Introduction

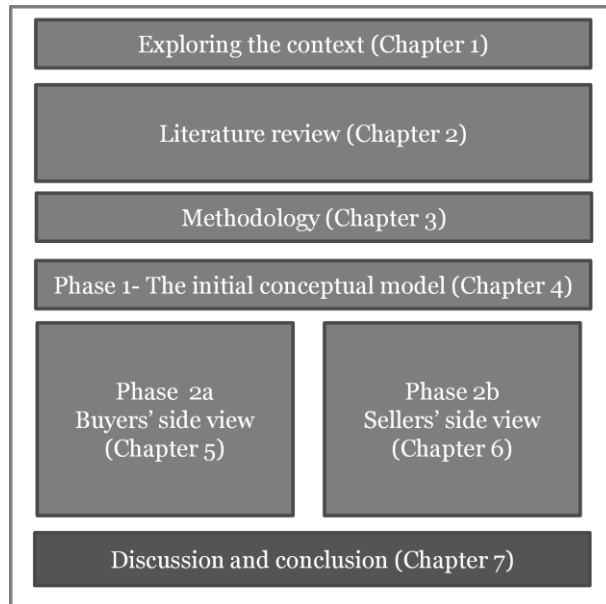
The purpose of this chapter is to discuss the findings and the contribution to knowledge made by this thesis.

This discussion is structured around a conceptual model which evolved in the three phases of the research following the approach explained in Chapter 3 to respond to the principle research question which is:

*What are the factors affecting the auditor selection decisions of FTSE 350 companies in competitive tenders?*

Auditor selection is an important decision given the critical role of audit in supporting the effective operation of financial markets and yet there is little previous literature on this topic. The most relevant UK literature in relation to auditor selection (Beattie and Fearnley 1995;

1998a; 1998b) predates much of the change that has occurred in the regulatory and competitive landscape in the FTSE 350 statutory audit market leaving a research gap in this important area.



### **7.1. The conceptual model**

The current research has explored how FTSE 350 companies have been making auditor selection decisions using an exploratory social constructionist research approach and based on interviews and interview records covering three research phases. These cover a period in excess of ten years of audit tendering, and include both buyer and seller perspectives. A conceptual model of auditor selection has been proposed. This conceptual model was introduced in Chapter 5 following the analysis of semi-structured in-depth interviews with those who had recently been involved in a tender on the buyer side. It was also supported by independent analysis following interviews adopting the same approach on the sales side and set out in Chapter 6. For convenience the model is set out again below and is discussed in the sections that follow.

In Section 7.1.1 the five selection factor groups, which are central to the conceptual model, are considered within the context of existing research and indications concerning interrelationships between them (as identified by the numbers above). Then, Section 7.1.2, looks at each of the factors within the factor groups in more detail, including for each, their inter-relationships. A summary of the overall contributions of this research within the context of the literature is then set out in Section 7.2.

The Discussion continues with consideration of the implications of this research for theory and practice and concludes by highlighting the limitations of this research and opportunities for future research.

### 7.1.1. The five factor groups in the context of existing research

The current research has identified that FTSE 350 companies within the context of the auditing, regulatory and market background and subject to independent contextual and individual / company background and individual circumstances (outside the scope of the research) have been selecting their auditors in competitive tenders as set out in the conceptual model in Figure 28.

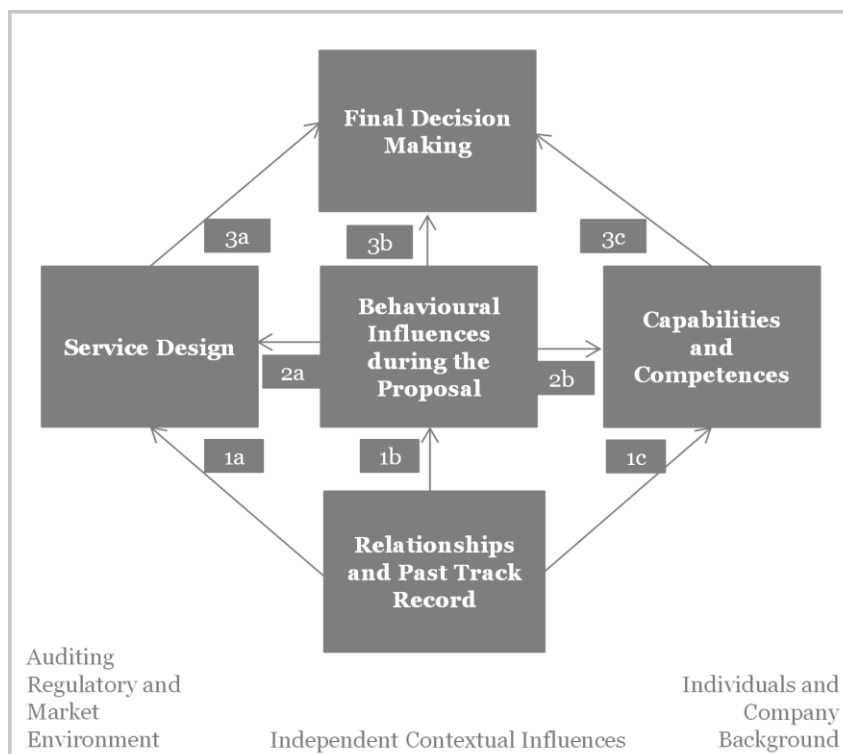


Figure 28: The revised conceptual model

The research discovered five important influences on auditor selection (factor groups): Relationship and past track record (at the start of the proposal process), Service design, Capabilities and competences, Behavioural influences during the proposal) and (the dynamics of) Final decision making. The conceptual model sets out these decision influences and also illustrates a

number of relationships between each one and which also emerged from the research.

The same five factor groups were present in each of the three phases and with one exception (Final decision making in Phase2b as discussed further below) were all present in over 90% of the interviews and interview records; providing consistent evidence of their influence on the auditor selection decision taken by FTSE 350 companies across the 111 interviews and interview records included in the research. Each is now discussed in turn; firstly at an overall factor group level (Section 7.1.1) and subsequently considering the individual underlying factors (Section 7.1.2).

### **Relationships and past track record**

This first factor group identified by the research relates to the influences of pre-existing relationships and past record on the auditor selection decision. This factor group was found to include the influence of those relationships between the selecting company and the competing firms which have arisen as a result of track records of service at the selecting company. These influences arise either through auditor incumbency or through firms providing non-audit services or investing in marketing and business development activity (“targeting”). This factor group also includes influences which have arisen as a result of service relationships at other companies; either in the past or current where cross-directorships are present. The factor group also includes the influence of alumni relationships, which are especially prevalent in the FTSE 350 audit market, and

other network influences (for example word of mouth) as explained in Section 1.4.1.

The importance of relationships in purchasing and selling has of course been extensively studied and emphasized (for example Berry, 1983; Sheth and Parvityar, 1995). The influence of relationships in managing uncertainty caused by intangibility and complexity in management consultancy supplier selection has also been identified (for example Perner and Werr, 2014). Perhaps surprisingly, given the nature of the auditor's responsibilities set out in Chapter 1 and the typically long periods of tenure which have in the past pertained, the influence of relationships on auditor selection is under researched in the literature as set out in Section 2.5 and a greater focus has been applied to other factors especially professional service competence and to a lesser extent behaviour.

One exception to this is in the area of auditor switching where past service has been identified as an antecedent for change (see for example Beattie and Fearnley, 1998a). Ironically given the recent regulatory changes highlighted in Chapter 1 and in Section 7.4.2 below (initially recommending and then requiring audit tenders as a means of improving audit quality), this previous research was concerned about threats to auditor independence which might be caused by greater levels of tendering and switching (Beattie and Fearnley, 1998a; Craswell, 1988). Comparison of the research findings with the auditor switching studies is returned to below in connection with Service design and again in Section 7.1.2.

The current research has identified important relational impact on auditor selection both directly and, as further explained in Section 7.1.2 through its influence on other selection factors. It therefore extends the study of the impact of relationships on supplier selection into the professional services and auditing situation.

The focus of relationship management literature (see for example Kalwani and Narayandas, 1996; Ryals and Rogers 2007) has tended to be on managing direct relationships between supplier and customer; including for economic advantage, but also considering matters such as trust (for example Doney and Cannon, 1997) and loyalty (for example Kuenzel and Krolikowska, 2008). Other research has looked at other influences such as alumni (Iyer, 1998; Iyer et al., 2000; Dhaliwal et al., 2014), and cross directorships (or interlocking directorates: Davison et al., 1984). Other researchers have considered word of mouth influences on supplier selection (for example Berry and Parasuramen, 1991) and specifically in professional services (Reingen and Kernan, 1986). These studies have looked at different aspects of relationships but have not looked across all of the relationships which might impact decisions. In the highly networked environment surrounding those making FTSE 350 auditor selection decisions the current research has enabled an holistic overview on all of these relationships and identified their influences in one decision context; namely auditor selection.

More detailed discussion of the individual constructs underlying the Relationships and track record factor is set out in Section 7.1.2.

### **Service design**

The second factor group influencing auditor selection is Service design. Even though the underlying audit is defined by law and regulation, the current research has identified that companies have still found it possible to differentiate between firms based on the core audit (normally associated with language such as rigour and assurance), and the facilitating services including audit coordination and communication, approach to accounting and technical matters, working with internal audit and approach to auditing IT systems and controls. Companies are also looking for insights and ideas from audit firms' broader experience.

These are interesting findings suggesting that customers may perceive perhaps surprisingly important differences between suppliers' approaches even in a highly regulated and therefore supposedly undifferentiated industry.

Generally, Service design in the context of auditor selection is under researched. There are studies considering audit quality more generally as an influence on auditor choice but these tend to be concerned with issues pertaining to auditor competence and especially the difference between the major firms and other firms (see for example DeAngelo, 1981; Francis and Wilson, 1988), rather than the facilitating and supporting services identified in the current research.

Auditor switching research mentioned above provides some inferences as to service design by identifying where service breaks down preceding a switch, highlighting service problems as a reason to change auditor (for example Beattie

and Fearnley, 1998b) and also issues associated with audit fees (Beattie and Fearnley 1995; Addams and Davis 1994; Hermanson, 1994). Research has also previously identified individual elements which have been considered during auditor selection processes. These have included, for example, guidance on accounting principles and quality of advice to management (Beattie and Fearnley, 1995; 1998a) along with the quality of working relationships (Beattie and Fearnley, 1995; 1998a; Eichenseher and Shields, 1983). Research has not however, previously considered the elements of the underlying audit service design which may be important to the auditor selection process comprehensively.

The current study has disaggregated what lies within the Service design influence. The use of the augmented service model (Gronroos, 2007) has also provided categorisation between the core service and especially helped to clarify the facilitating services and supporting services.

The current research confirms that companies are not using models such as those associated with the traditional procurement models summarised by Huang et al. (2007) and Ho et al. (2010) and focussed on defined factors such as quality, performance and price. They are instead evolving their audit service as part of the proposal process consistent with the services supplier research (for example Ellram, 1990). This also provides support for the extension of Service Dominant Logic (Vargo and Lusch, 2004) in the context of auditor selection as it identifies Service design as an evolving process throughout the proposal process. As will be returned to below in this section under Behavioural



influences there is evidence of firms testing their ideas and companies testing firms' ideas and propositions before submission of final documents.

As with the Relationships and past track record factor group, the detailed factors underlying the core, facilitating and supporting services are set out in Section 7.1.2.

### **Capabilities and competences**

Of the five factor groups influencing auditor selection, the Capabilities and competences group has been most widely discussed in the prior auditor selection research. This is perhaps not surprising given the high degree of expertise of professional services firms (as summarised by Ojasolo, 2007 and set out in Table 11) and their credence qualities, giving rise to performance ambiguity as defined by Bowen and Jones (1996).

Within the auditor selection context, there have been two ways of looking at capability and competence. The first has involved considering features of the selecting organisation which might drive a company to appoint a particular type of firm (as described for example in Chapter 2, in relation to companies with higher agency influences and outside/non-executive directors seeking to appoint major firms (Beattie and Fearnley, 1995; Francis and Wilson, 1988)). These have been connected with issues around information asymmetry and institutional and non-executive (or "outside") director influences concerning sending signals to the market or protecting personal reputation (for example Bar-Yoesef and Livnat, 1984; Blouin, et al., 2007 and Firth and Smith, 1992).

The second approach has involved consideration of attributes of the firms and these have included assessments of aspects of the firm as a whole, of the team and at the lead partner level (Almer, 2014; Beattie and Fearnley, 1995; Hermanson et al., 1994; Sands and McPhail, 2003). Across the three levels the previous research suggests assessments being made of industry and technical expertise and to a lesser extent geographical influences such as international reach and accessibility (Addams and Davis, 1994; Almer, 2014; Beattie and Fearnley, 1995; Sands and McPhail, 2003).

The current research lends support to previous approaches also identifying different levels of assessment within auditor selection and extends the previous research to explain the factors underlying each level. This research also extends previous research by identifying that companies are not only focussed on the presence of Capabilities and competences, but also on their confidence of whether and how they will be delivered, which has generally not explicitly been a focus for previous research (see for example Baldacchino and Cardona, 2011). These kinds of influences bring in issues of conflicts for firms and teams (which would preclude apparently ably qualified bidders) and of style and potency for the lead partner (companies wanting assurance that they can deliver the resources of their firm).

As with Service design (above) the current research provides indications that the assessment of Capabilities and competences presented by the teams evolves during the proposal process as teams are changed in response to feedback provided and perceptions are altered. This finding extends previous research such as Beattie and Fearnley, 1995; 1998a; 1998b, Eichenseher and

Shields, 1983 and Sands and McPhail, 2003 who consider assessments at a single point in time.

The Capabilities and competences factor group will be returned to in more detail in Section 7.1.2.

### **Behavioural influences during the proposal process**

The current study has identified a wide range of behavioural influences on auditor selection which appear to go well beyond compliance with the tender process and the submission of high quality proposals and presentations.

Companies are being influenced by the behaviour of the teams in proposals (and teams appear very aware of it). This includes the quality of interaction that takes place, the demonstration that the firms actually want the work and care about delivering the service that is being sought, and the results of activities used by companies to test and prove the people and their propositions and as well as firms testing and refining their ideas. This current research therefore supports past research by Beattie and Fearnley (1998b) who commented that economic theory is deficient in relation to auditor selection and that there is a need to incorporate behavioural factors into theoretical explanations of the choice process. The emergence of this factor group provides further support for previous research finding that personal client auditor relationships can be important (Eichenseher and Sheilds, 1983; Beattie and Fearnely, 1998b). Beattie and Fearnley (1998b) found that in selecting a new auditor the relationship with the proposing team and “chemistry” were important and, as noted in Chapter 2, called for in-depth interviews to provide

additional insight into the auditor selection process (Beattie and Fearnley, 1998b). This current research has undertaken that approach and provides additional insights as to the nature of behaviour taking place in these personal interactions.

The current study therefore identified a rich set of data providing new insights into the influence of behaviour directly on the auditor selection decision and, as will be returned to below, through its influence on other factors. The study therefore provides a constructive extension to pre-existing research in this area.

This area will again be returned to and considered in more depth in Section 7.1.2.

### **Final decision making**

Lastly, the current research reveals that outcomes of audit tenders are being influenced by the dynamics of Final decision making. This includes the weight that is assigned to different stages of the process, the final decision discussion and the people involved.

Although the current research identified companies investing time to try to make processes fair and comprehensive they (also as noted above) were not conducting statistical or other mathematical modelling or seeking to develop algorithms, as the traditional supplier selection literature (explored in Section 2.1) surrounding the purchase of goods might suggest. Although many used checklists and obtained structured feedback this was in most cases used to

support decision making rather than drive it. This suggests that the checklists and feedback obtained were only part of an assessment and that other factors, including intuitive assessments may also be present. This would be consistent with Kahneman (2011) which suggests intuitive decision making where decisions are more complex than can be processed cognitively.

The current research also provides support to Kahneman et al.'s (2007) identification of a tendency for decision makers to give undue weight to more recent problems or phenomena which they refer to as the bias of “recency” (Kahneman et al., 2007). In the current research the focus of comment in relation to the final presentations is a potential indication of bias of recency since, in what is typically a comprehensive process, it seems unlikely that the final presentation would add materially to judgements of the auditor's competence or other objective criteria.

The concept of “satisficing” (Simon, 1997) is interesting in the context of an auditor selection decision. As explained in Chapter 1 and considered in the discussion of the auditor selection literature in Section 2.5, those making auditor selection decisions are typically faced with (at least) four credible bidders (“The Big 4”) who could *prima facie* conduct their audit to a satisfactory level. This research however confirms that they nonetheless invest in comprehensive processes to identify a preferred auditor. One possible interpretation of this is that satisficing is operating at a shortlisting level but that final decision making is more complex involving each of the influences identified in the conceptual model – including relationship and behavioural/experiential influences not always consistent with rationality.

The current study extends research into the auditor selection process by recognising the influence of the Final decision making process and dynamics which had not been previously explored in the context of auditor selection.

### **Indications of relationships between the five factor groups**

Although the objective of the research was to identify what were the influences on auditor selection decisions by FTSE 350 companies, a number of interesting inter-relationships between the five key influences also started to emerge from the research and these are reflected in the conceptual model.

These inter-relationships are identified by the numeric labels on the model and are of three types:

1. The influence of Relationships and past track record arising from experience prior to the proposal process.
  - a. Past experience was identified as having created expectations of Service design. Companies were identified as focussing on recent problems and past experiences of good service in helping them to ascertain what they wanted in their future service. In the absence of perfect information, companies were focussing on only certain aspects of service design which occurred to them as mattering most. Recent experience was also helping them to frame the decision consistent with. Kahneman and Tversky, (1979).
  - b. Past behaviour was identified as being interpreted as an indication of likely future behaviour.

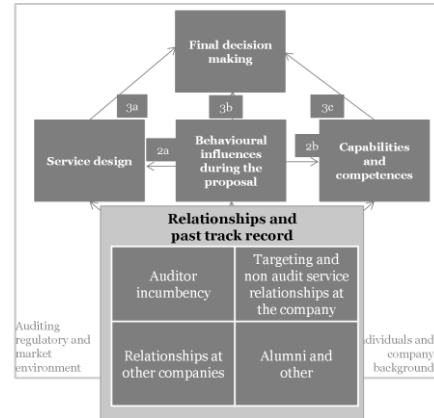
- c. Where Capability and competence had been demonstrated in the past this was seen as evidence that these capabilities and competences would be demonstrated in the future.
2. The influence of behaviour during the proposal process
  - a. Service design is evolved throughout the proposal process as firms test their ideas and listen and respond to what they hear consistent with the nature of services procurement identified by Ellram et al., (2008) and van der Valk and Wynstra, (2014).
  - b. Companies are also testing firms and their people throughout the proposal process. Their assessment of Capabilities and competences is a dynamic one which evolves during the proposal process including the final presentation.
3. The influence of Service design (3a), behaviour during a proposal process (3b) and Capability and competence assessment (3c) on Final decision making. Again this is consistent with the services supplier selection literature referenced above.

The inter-relationships between the five factor groups are considered as part of the discussion of their detailed definitions which now follow.

### 7.1.2. Detailed definitions of the five factor groups

#### Relationships and past track record

The relationships and past track record factor group has assembled all the factors affecting auditor selection which arise from the relationships and service history pertaining at the start of the proposals process. The exploratory grounded approach



to the research identified relationship and track record influence going beyond the individual company and current auditor. There were also influences from the company's relationships with other firms and past and current service relationships at other organisations and of influences related to the selectors' prior employment with the firms (alumni relationships).

The factors identified related to:

1. The relationship and service history which a company had with its incumbent auditor including the influence of service quality (or more normally problems) and the feelings and opinions companies had about incumbency versus a new auditor or fresh approach.
2. The non-audit service track record between the company and the non-incumbent firms either through other service relationships (such as tax and consultancy) or marketing activity (targeting as previously defined).



3. The past service track record that individuals in the selection committee had experienced with the firms or individuals within the firms in their previous employments or current cross directorships.
4. As (as identified in Chapter 1) a high proportion of those involved in auditor selection are alumni of the Big 4 firms, the influence of that past employment.

The benefits of collaboration and co-development were identified in the traditional supplier selection literature review in Section 2.1.1 and included more synergistic and longer term benefits. Although a number of these benefits were goods related, more general benefits such as building supplier confidence levels (Johnston et al., 2004) better use of customer knowledge (Paulin et al., 2000), and operational factors (for example non-retrievable investments, shared technology and relationship influences such as trust and commitment (Wilson, 1995) were also identified.

The value of long term relationships (Sheth and Parvityar, 1995) and the different nature of exchange in an ongoing relationship (MacNeil, 1978) were highlighted in Chapter 2, along with their positive impact on sales performance and market share (Crosby et al., 1990; Morgan and Hunt, 1994).

The current research however identified that, in the particular circumstances of an audit proposal, a number of factors play against such potentially positive influences and help to explain the high levels of switching involved with audit proposals identified in Section 1.4.2.

For example the current research identified that audit proposals commonly take place against a backdrop of service problems with the incumbent auditor. This was especially prevalent in Phase 1 and especially related to problems in resolving accounting problems but also prevalent in Phase 2. These current research findings are consistent with and support some of the findings of Beattie and Fearnley (1998a) which found that, in many cases, the proposal had been initiated as a result of service problems.

The current research however also identified other factors which favoured change. The research identified that an incumbent auditor faces a number of inherent challenges. All three phases of the research identified an inherent attractiveness of new ideas and approaches which could occur even where the incumbent had a positive track record. Where an incumbent responded with proposals for improved services or just new ideas they faced the “Why now?” challenge. This is new a new insight in auditor selection research having not been explicitly researched before.

And in Phase 2 in particular, in an increasingly regulated and high profile environment, change appeared more attractive even absent service issues. This updates and extends the research of Beattie and Fearnley (1998a).

The current research also identified that the initiation of the proposal is set against a number of other relationships which a company has with non-incumbent audit firms. These relationships arise from a number of sources including; targeting and non-audit services provided by non-audit incumbent

firms, past service relationships and current cross directorships at other companies, and alumni connections.

These relationships were discussed in a high proportion of the interviews as set out in Figure 29.

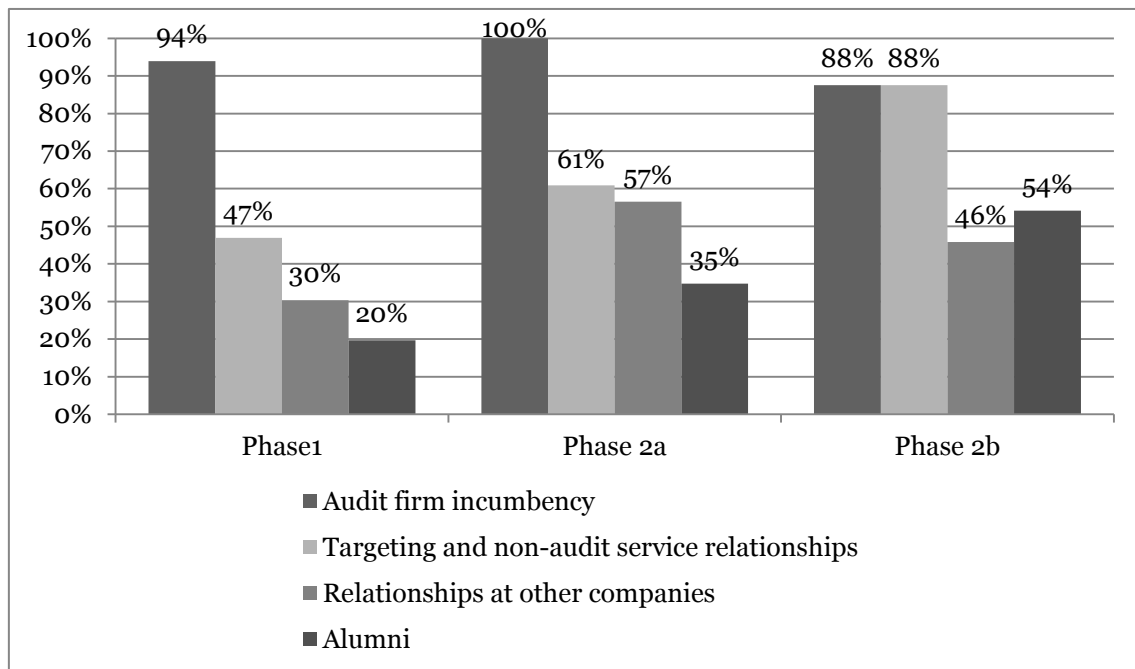


Figure 29: The proportion of interviews and interview records which referenced relationship and past track record influences on auditor selection

The multi service nature of the Big 4 firms facilitated relationship building through the provision of non-audit services and targeting of the audit. And new people often brought pre-existing relationships with firms and individuals which could exert a critical influence on their decision making. Indeed these relationships may have triggered the proposal in the first place. So relationship influences were not restricted to the incumbent auditor. These broader relationship influences are interesting and extend that previous relationship literature which has focussed on the buyer-seller relationship, for example

relationship marketing approaches (e.g. Sheth and Pattayar, 1995) and key account management approaches (e.g. Ryals and Rogers, 2007).

Interestingly the current research identified (within those influences related to relationships at other companies shown in Table 29) more evidence of the influence of past service relationships at the relevant company and past experience of directors working with firms at their previous employments. There was little discussion of current cross directorships as an influence which challenges the findings of Davison et al. (1984) who identified a high correlation between companies with common directors and their appointed auditor. It is not clear why the current research contrasts with this previous study but it might be evidence of directors in such situations compartmentalising their relationships; treating appointments at different companies separately and distinctly.

The influence of alumni in auditor appointment had previously been identified and in most cases has been identified or implied as positive for their previous employer (Lennox and Park, 2007; Iyer, 1998; Kotler and Bloom, 1984). The current research extends our understanding of alumni influences in auditor selection and suggests that the influence of alumni although mostly positive can be variable, and that any such influence is more often likely to be a “coaching” influence, helping their old firm to get to the right service proposition and feeding back on their performance in the proposal process more generally.

In relation to more general relationship influences the literature suggested an important role of trust in relationship development and in increasing cooperation and reducing uncertainty (Morgan and Hunt, 1994; Selnes, 1998). The important and trusted role of the auditor was explained in Chapter 1. The current research provided conflicting evidence. Whilst in Phase 1 there was very little reference to trust, in Phase 2a it was seen both as an important element to support a company's decision to switch and as a desired part of the future service relationship.

The current research however did not generally support the influence of auditor/auditee loyalty in auditor selection. Previous research had identified bonds in professional services (Kuenzel and Krolikowska, 2008), but there was little discussion of it in any other three phases and indeed some evidence that it had been deliberately discounted. The presence of problems on the service track record as mentioned above may have influenced this although evidence of sustaining relationships from past track records at other companies may indicate loyalties to other firms based on experience in other companies. In the highly networked situation of the FTSE 350 the current research identified examples of personal loyalties as a result of past service relationships which in some cases appeared more influential than the loyalty to any particular firm.

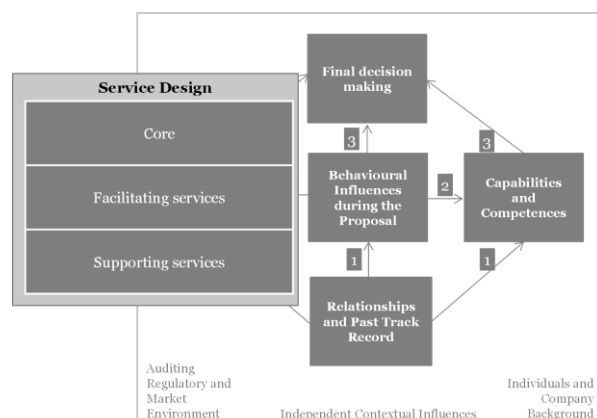
Lastly, the current research challenges the influence of word of mouth influences in FTSE 350 auditor selection. Word of mouth had been identified as having a important influence on purchase decisions (Arndt, 1967; Herr et al., 1991; Richens, 1993) and especially in professional services (Reingen and Kernan, 1996) but the current research identified very little discussion of word

of mouth influences and moreover across all three phases, little mention of references. Indeed where references were discussed they tended to be post decision confirmation. This lack of mention of references is perhaps also surprising given the important role which referrals have been seen to play in more general customer relationship management (Stahl et al., 2003) both in generating new sales and through the positive effects these can create when associated with respected brands. In formal processes with so few suppliers it appears that referrals played little or no role. It is also worthy of note that each of the Big 4 has an established reputation and its audit clients are publicly available. This latter fact means that the positive reputational effect of serving reputable companies can be achieved without direct contact with them.

### **Service design**

The Service design factor group brings together those factors identified in the research which related to the influences on auditor selection arising from the firms propositions related to how the audit service would be designed and delivered. The research suggested that the audit service design could be differentiated.

The individual factors underlying Service design have been organised following an augmented service model based on the work of Gronroos (2007) and including three factors:



1. The core audit – this factor is based on the underlying technical quality of the audit. Following the work of De'Angelo (1981) this would relate to the likelihood of auditors identifying and reporting material errors in the financial results of a company. Companies might therefore be looking for an underlying core audit which is robust and rigorous; thereby providing them with assurance that their results are materially correct.
2. The facilitating services which are integral to delivering the core service. The current research identified five of these facilitating services: organisation of the working relationship, accounting technical issue resolution, communications and communication, reliance on the company's IT and systems and working with internal auditor. All were present in all three phases of the research except the organisation of the working relationship which was absent from Phase 1. The reasons for this are not known.
3. Supporting services which come out of the delivery of the service. This was found to relate to insights which audit forms offered to provide from benchmarking companies' practices and offering other ideas from similar companies. Importantly this was a by-product of the audit and did not relate to the provision of other non-audit services.

As outlined in Section 7.1.1 (Page 410) companies were not using the sorts of models which the traditional supplier selection literature might expect. Instead they were evolving their service requirements as predicted by the

service selection literature and Service Dominant Logic. In Section 2.5 the limitations of that auditor selection literature which had used questionnaires to ask companies what would be important to them in auditor selection. The current research challenges such approaches as it is unlikely in an evolving process that companies would be fully aware of what might influence them until they had actually experienced such a process.

In relation to the individual factors identified, the current research validates previous research by Beattie and Fearnley (1995) and Sands and McPhail (2003) which highlighted the working relationship with the lead partner and the team and aspects of the service (courteousness) as important influences on auditor selection. Additional perspectives were however also highlighted around the importance of sensitivity and fit with a company's culture and, notwithstanding the regulatory environment, a desire to work in partnership including mutual respect. The current research also validated the work of these two researchers who had also identified aspects of communication and dealing with accounting issues. to be important influences (Beattie and Fearnley, 1995; Sands and McPhail, 2003).

In relation to facilitating services the current research added additional insights in relation to the influences that reliance on the company's accounting systems and controls and about the organisation of work with internal audit which had not specifically previously been identified as influences on auditor selection. Because many of the previous studies had examined drivers of auditor change, there was less focus on aspects of service which could be valued but, had not been areas of service problem or failure.



In Section 2.5 above a preference for Big 4 firms was identified where agency costs were high and this was associated with a desire for greater audit quality. In some cases (Abbot and Parker, 2000; Beasley and Petroni, 2001) this desire for audit quality was linked to the appointment of firms specialising in the relevant industry. The current research however identified that audit quality is not the only driver for a desire for industry specialists. Companies identified that they expected their auditors to share best practice from other companies in their industry (and more widely) as part of their audit service. The importance of knowledge, experience and expertise sharing in the context of management consulting has been highlighted (for example by Lowendahl et al., 2001; Sonmez and Moorehouse, 2010). This research supports that desire for access to knowledge, experience and expertise in the highly regulated audit environment. Where non-audit services are restricted, companies are still looking to benefit from relevant knowledge, experience and expertise but as a free by-product of the audit service.

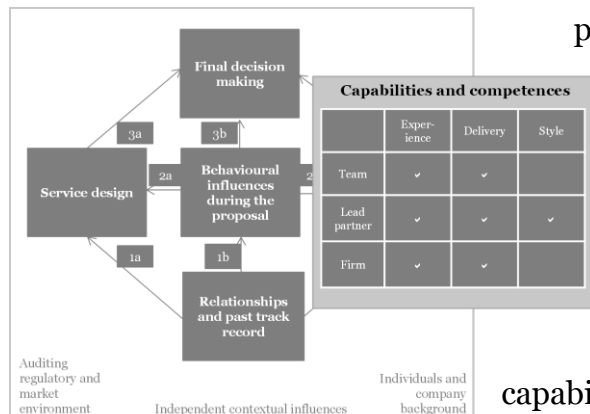
Previous research which suggested that the availability of non-audit services from the auditor was an influence (Beattie and Fearnley, 1998a) has been overtaken by regulatory change. Rather than this being a positive influence there is at least some evidence from the current research that the desire for companies to work with key specialists may lead them not to appoint the relevant firm as auditor.

Lastly in relation to Service design, the current research validates Beattie and Fearnley's (1995) research that fees are not critical to auditor selection in most cases as long as they fall within an acceptable range (also more recently

Almer, 2014) This challenges other research (for example Sands and McPhail, 2003) which had asserted the importance of fees to auditor selection. Some of this may be explained by smaller companies having demonstrated a greater sensitivity to fees (Addams and Davis, 1994). The current research identified that although audit fees *may* still be important they are not influential to auditor selection either because their quantum is low compared to other expenditure of the company, or that the quoted fees are very close, or because fees are considered to be something which is negotiated after the preferred bidder has been identified based on the assessment of other criteria.

### **Capabilities and competences**

The conceptual model identifies three levels of assessment with the capabilities and competences factor group which were present in each of the



phases. These levels of assessment

included both considerations of the underlying capability and competence being assessed but also considerations of how these

capabilities and competences may be

accessed by the tendering companies. The three levels of assessment were:

1. The firm – including general comparison between the Big 4 and of that group compared to the next or Mid tier firms, the industry expertise of the firm and geographic spread but also addressing issues such as conflicts or perceived conflicts with other clients (normally competitors

of the tendering company) and with other non-audit services given independence requirement faced by auditors as explained in Chapter 1.

2. The team – including assessment of individual members of the team (excluding the lead partner) and their experience and also references made to the assessment of the teams as a whole. This included industry experience, issues related to geographical location and the structure of the team; especially the organisation and responsibilities relating to its leadership.
3. The lead partner – including assessment of their experience but also their style and the companies' perceptions of how effective they would be in delivering the resources of the firm and leading their teams.

Because many of the studies into auditor selection have been conducted using a questionnaire approach and in many cases with predefined selection criteria, with some exceptions (Beattie and Fearnley, 1998a; Sands and McPhail, 2003) they have tended to neglect this multilevel assessment. The current study validates recent research (Almer et al., 2004) that suggests the operation of these three levels of assessment in the auditor selection context.

The presence of three levels is important to understanding Capabilities and competences because assessment appears to being undertaken at all three the different levels. And whilst some influences are present across all three levels others are specific to one or two.

The current research validates the influence of industry expertise on auditor selection as identified by a number of previous studies (for example Addams and Davis, 1994; Eichenseher and Shields, 1983; Heramnson et al., 1994) at all three levels. Industry experience was seen both as a positive influence when present and as a concern when absent. It also validates previous research identifying the need for technical competence (Beattie and Fearnley, 1998b; Sands and McPhail, 2003)

The findings in relation to geographical decision influences present a more mixed picture. The presence of geography as an influence is supported by the current research findings that show international coverage and strength in key locations both at a firm and team level being influences on auditor selection. There is also evidence to support the fact that consideration of strength in depth (including especially experience of working with FTSE 350 companies) can be important for UK regional offices where companies are headquartered or have substantial operations outside London.

The current research provided a mixed picture of the influence of geographical location on auditor selection. It therefore extends previous research by providing insights into the circumstances under which when geographical factors may be influential to selection and when not. So, companies were found to be looking for strong partners in key territories and assessing them; including at final presentations. This might suggest a focus on accessibility as identified in some previous research, (Scott and van der Walt, 1986). However the current research also identified where companies preferred or insisted on their service team led or provided from London. Most FTSE 350

companies do now have their headquarters in London and it is therefore there that most of the expertise in dealing with issues facing these companies resides and for some at least, the staff are considered of higher calibre. A relative lack of importance attached to geographical accessibility is consistent with previous research by Beattie and Fearnley (1998b) who found geography to be a secondary influence and Sands and McPhail's (2003) who found it to be relatively less important than other factors.

The three levels of assessment however become most differentiated at the delivery level. That is to say that the current research has identified that companies are not only looking to assess the competing firms on whether they have Capabilities and competences, they also want to understand how well they will be able to access those capabilities and competences:

1. At the firm level conflicts of interest were identified as an important consideration. Firms may have strong, highly relevant experience and expertise, but companies are concerned to ensure that there are no perceived conflicts with their competitors (either because of heightened concerns about confidentiality or because of concerns over resourcing) or with other non-audit services (access to audit capabilities and competences may preclude access to other services).
2. At the team level structure and responsibilities and accountability were identified as important. This was especially in relation to the structure of the lead team and the opportunities and potential complications that could arise by having the team led by one partner or two.

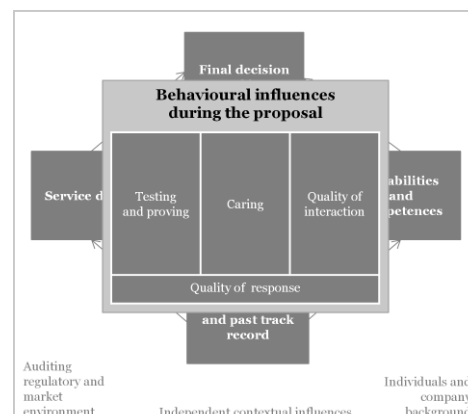
3. For the lead partner, the current research identified that as well as possessing the relevant experience and expertise, companies want to be confident that the lead partner will deliver the resources of the firm. They are therefore looking for leadership qualities and presence.

The current research therefore validates the presence of industry, technical and geographical influences on auditor selection generally, but also extends this research both by validating the presence of these factors in the FTSE 350 context and providing additional insights as to how these influences may be operating. By examining capability and competence assessment on three different levels this research also provides additional richer insight.

Lastly, the current research identifies that competence and capability assessment evolves throughout a proposal process as firms present and prove their credentials and companies test them; and as firms make changes to their teams as they learn more about companies in the proposal process and respond to feedback that they are given. This is returned to below under Behavioural influences during the proposal process.

### **Behavioural influences during the process**

This factor group includes all of the influences on auditor selection which were associated with behavioural interactions which took place during the proposal process. Both companies and partners recognised the influence of



complying with the invitation to tender and delivering a high quality response. However a number of other influences were also identified which go beyond merely meeting the requirements of the tender. Additional detailed constructs are therefore included within this factor group. These include factors related to:

1. The influence of the nature and quality of the interactions which took place during the proposal process in meetings, presentations and more informally. This includes both interactions between companies and the proposing firms and the interactions which companies observed between members of the proposing teams (teamwork).
2. The importance of companies feeling that the proposing firms and their teams were interested in them and cared about the work. This included teams demonstrated that they listened, understood and (importantly) responded to what they were told by the companies. It also includes other behaviour which signalled how important the audit was for the teams involved and their firms including demonstrating hunger, energy, enthusiasm and commitment.
3. The mutual testing and proving which took place during the proposal process. This included companies testing and challenging the competence of the teams being put forward and their propositions whilst the firms were themselves testing their ideas and proving their capabilities and competences.

Behavioural influences during the proposal process are important because they affect the Service design and Capabilities and competences factor groups as outlined above and because they influence final decision making directly.

The existing auditor choice literature (Beattie and Fearnley, 1998b) has identified deficiencies in applying economic theory on its own in attempting to explain selection decisions and recognised the likely influence of behavioural factors (Beattie and Fearnley, 1998b). More recently a range of influences on auditor selection has been suggested (Baldacchino, 2011). The influence of relationships is recognised (Beattie and Fearnley, 1998b) and inter-personal influences identified as desirable in service design (as confirmed by the current research and noted above). However the current study identified that auditor selection decisions are influenced not only by the existing relationships and service design (although these are two of the five factor groups affecting auditor selection as previously discussed).

The influence of behaviour during an audit proposal process has been recognised in previous auditor selection research. Davis (1994) identified the importance of the relationships developed between competing auditors and senior client personnel during the proposal process and, in other professional services literature, where behaviour during a proposal process acted as a signal for what might follow. This might include good interaction (Day and Barksdale, 1992); sharing of ideas and examples (Sonmez and Moorehouse, 2010), and demonstrating gravitas as a signal of quality (Stock and Zinszer, 1987). The importance of behaviour during the sales process is of course also widely



recognised in for example adaptive selling (see for example Predmore and Bonnice, 1994).

The current research however has confirmed the influential role of behaviour in the auditor selection process but also considerably extends previous research in this context by identifying the three different behaviour types in operation, in addition to complying with the request for proposal and responding with a high quality proposal.

Some interesting findings also emerged from the current research by comparing across the categories using the number of references (as opposed sources which has been used consistently so far). The limitations of Phase 1 in this regard were recognised and acknowledge in Sections 3.2.3 and 4.1.

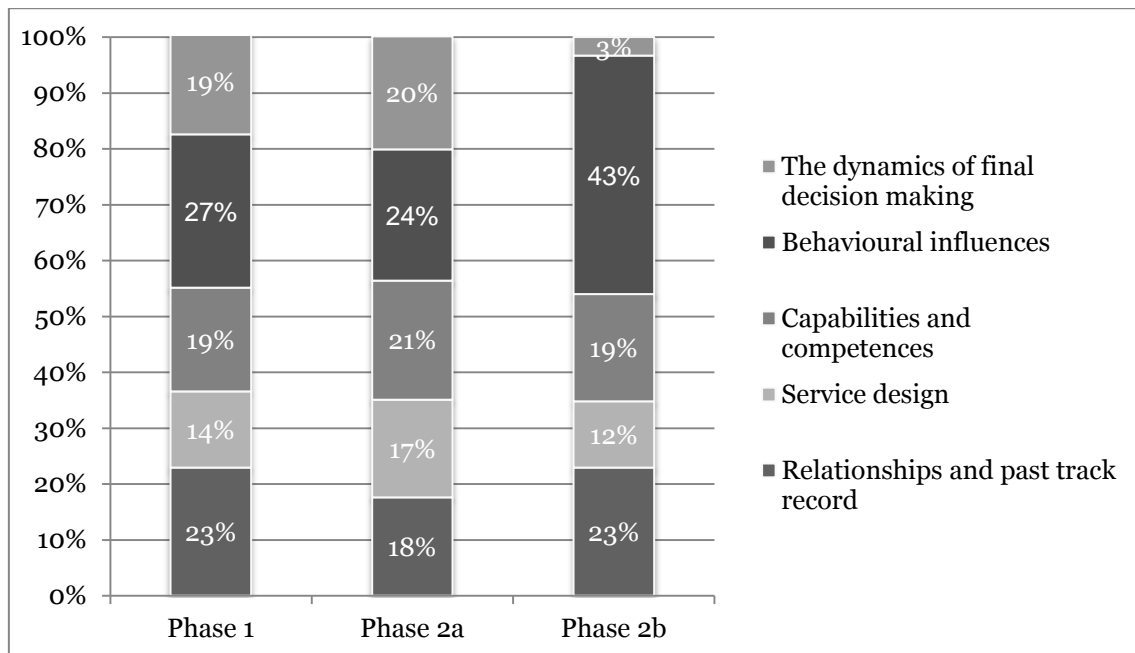


Figure 30: Comparison of numbers of references for each factor group across the three phases of the research

Figure 30 shows the percentage of references identified for each higher order category and for each phase of the research.

The presence of the five factor groups affecting the auditor selection decision has previously been discussed and the high degree of consistency across the phases also noted. However Figure 30 also highlights two important differences.

The first, relating to Final decision making is unsurprising. The small percentage of discussion in Phase 2b of final decision making highlighted is consistent with the fact the partners interviewed were not present during the final decision discussion. Final decision making is discussed next.

The other striking difference however is in the proportion of discussion in the Phase 2b partner interviews that was concerned with behavioural influences on the auditor selection decision. Although such behavioural influences on the auditor selection decision were most referenced in each phase of the research for the Phase 2b partner interviews they represented almost double the next most referenced category (Relationships and past track record) and approached half of all the references pertaining to these categories.

The partners therefore appear to believe that behaviour during a proposal process is more important than the companies do. It is not clear why this may be the case. It may be that partners are over-emphasising the importance of behaviour; perhaps feeling that their performance in a proposal process is able to compensate for other potential weaknesses in their proposals. Alternatively, companies may be under-estimating the influence of behaviourally related

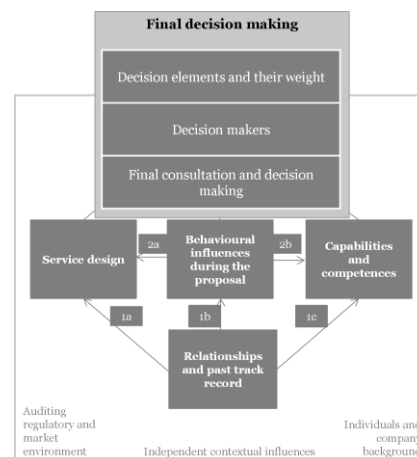
affective influences. So whilst they may feel that they are making decisions informed by “harder” assessment of Capabilities and competences and Service design, they may be being more influenced than they realise by behaviour. Whilst both groups see behaviour as important there is a question for those involved on the buyer side and sales side as to the appropriate weight and attention to be given to such influences.

The discovery of the differences in perspectives between buyers and sellers in audit proposal provides a new insight and a potentially highly interesting area for future research. This area is returned to in Section 7.4 where research limitations are discussed.

### **Final decision making**

The current study identified that auditor selection decisions made by FTSE 350 companies are normally made at the end of the proposal process, after final presentations by the firms and involve a discussion amongst those formally identified as being on the selection committee and other influences.

This factor group includes those factors which formed part of the final discussion process and therefore includes:



1. The elements of the proposal process that informed the final decision including the meetings during the process, the documents that were submitted and the final presentations.
2. The people that were involved in the presentation and their roles.
3. The nature of the discussion which took place in arriving at a final decision.

The current research identified that, in Final decision making, companies were being influenced by what went on at various stages of the proposal process. This included the individual meetings that took place and their overall organisation, the documents that were submitted (although in many cases these appeared to be of lesser influence) and the final presentations which were most influential. This research therefore provides additional insights into decision making with respect to proposals. Beattie and Fearnley (1998b) suggested that the auditor selection decision process included: initiation of an idea, invitation to tender, presentation, evaluation and final decision. Although the current research confirms the importance of the presentation in the decision, it also challenges models of auditor selection that appear to under estimate the complexity of the underlying process.

It has also been suggested (Frances and Wilson, 1988) that the auditor selection decision is taken in two parts. Firstly a decision is taken to change auditor and this is then followed by the selection of a new auditor. This current research challenges this assertion. Although service problems were observed (especially in Phase1) to place an incumbent in a difficult position, and

there may also be inherent pressures to change, no decision, at least formally, appears to be being made until the end of the process.

The current research identifies that the auditor selection decision was being taken in most cases by a selection committee comprising audit committees and management. In the context of an emerging corporate governance environment it might have been expected that the dominant influences in this process would be the audit committee. This research however identified a range of influence.

Whilst it was accepted that the overall responsibility for the decision and the process was laid with the audit committee and in some cases there was very active involvement of the Audit Committee Chair, in practice financial management and, in particular the Finance Director, remained highly influential in many cases. This was identified by Beattie and Fearnley (1998b) before many of the changes affecting corporate governance in the UK; however it is interesting that this has persisted. The current research suggests that many audit committees understand their role in overseeing a fair process and ensuring that there are competent bidders once this is achieved they have been seen to pass the decision back to management. The continued influence of financial management in auditor selection was recently supported in another (Canadian) context (Fiolleau et al., 2013) even many years after the passing of the Sarbanes Oxley act which, in common with the UK Corporate Governance Code, places responsibility for auditor selection with audit committees.

The current research also identifies evidence of individuals adopting behaviour consistent with their role as identified in another context by Carlson et al., (2000). In particular there were distinct roles played by audit committees and by management. The current research identified examples of individuals behaving differently in different proposals depending on whether they were Finance Director or Audit Committee Chair.

Final decision making, as noted previously, appears to being informed by Service design, Behavioural influences during the process and Capability and competences assessment (which in turn are influenced by Relationships at the start of the proposal process) and influences the auditor selection decision in three ways each of which is captured as an underlying factor in the current research.

In most cases the results were seen to be close decisions but that consensus could be reached; involving other Board members in the rare occasions where this was not the case. Given the research approach adopted it proved difficult to gain a deep understanding of the nature of these final discussions. This is also returned to in Section 7.4 where limitations of the current research are discussed.

## **7.2. Summary of contributions of the research**

### **7.2.1. Introduction**

This research increases our understanding of the factors affecting auditor selection in the FTSE 350 (a summary of the auditor selection research is set out in Appendix II).

The limitations of the existing auditor selection research were set out in Section 2.5; Table 28 below sets out how they have been addressed by the current research.

In addition, only two studies of auditor selection have identified which examined both the buy side and supply side perspectives as addressed by this research , which therefore provides a fuller and richer perspective on auditor selection decisions.

This section first sets out the specific contributions to theory and knowledge of the research and then the contributions to practice. The next section discusses implications of the research for theory and practice.

Previously identified limitations of existing research (see Section 2.5)	Current Research
Studies have predominantly involved questionnaire based surveys. Whilst this has enabled responses to specific questions to be identified, it provides little evidence as to what influences are in play as decisions are arrived at and how they might evolve during a process. The last UK based interview research included only 12 interviews.	The current research includes 111 interviews and interview records enabling a much richer picture of the influences on those selecting auditors
Most prior studies have included companies who have never conducted an audit tender and so they are hypothesising about what would happen should they do so.	Only those who had recently completed a tender at the time of the interview were included within the research
Studies have been undertaken in a number of different populations and jurisdictions. Whilst it can be worthwhile to consider a number of different perspectives, auditor choice may well be different given the different pertaining cultural and regulatory environments and especially between different market segments (private, smaller public and larger public companies).	The survey population includes only those companies which were in the FTSE 350 at the time of the tender.
The empirical research in the United Kingdom predates much of the regulatory and market activity summarised in Section 1 and in particular, the Enron scandal, the collapse of Arthur Andersen, developments in the regulatory environment and the significant focus on the roles and responsibilities of audit committees that followed.	The study covers an important period of evolution of tendering in the UK from the creation of the Big 4 to the introduction of recommended tendering by the Financial Reporting Council.

Table 28: Addressing the limitations of previous auditor selection research

### 7.2.2. Summary of contributions to theory and knowledge

Given the paucity of literature in relation to auditor selection and consistent with the resultant exploratory approach undertaken a number of references to consistencies, extensions or challenges to prior research were discussed in Section 7.1. This section now brings this together under the four principal contributions to theory and knowledge of this research.



The contributions are set out in summary in Table 29 and discussed in the text that follows.

Contribution	Supporting discussion form Section 7.1	Relevant literature	Theoretical/ conceptual basis	Nature of contribution
<b>Contributions to theory</b>				
1. A conceptual model of FTSE 350 auditor selection	<ul style="list-style-type: none"> <li>• Conceptual model of FTSE 350 auditor selection</li> <li>• Comprehensive view of behaviour in auditor selection</li> <li>• Different buyer and seller perspectives on behaviour</li> </ul>	<ul style="list-style-type: none"> <li>• E.g. O'Shaugnessy &amp; O'Shaugnessy (2005)</li> <li>• Perner (2013)</li> <li>• Simon (1997)</li> <li>• Kahneman (2011)</li> <li>• Payne (2008)</li> </ul>	<ul style="list-style-type: none"> <li>• Rational choice theory</li> <li>• Behavioural decision theory</li> <li>• Varying purpose/ nature of encounters</li> </ul>	<ul style="list-style-type: none"> <li>• Challenges rational choice and bounded rationality</li> <li>• Provides some support to heuristic theory</li> <li>• Argues for a comprehensive, conditional/ experiential approach</li> </ul>
2. Relationships are contextual and based on compartmental view (rather than based on more general loyalty – trust)	<ul style="list-style-type: none"> <li>• Nature of incumbent relationship at the start of the process</li> <li>• Influence of cross directorships</li> <li>• Influence of alumni</li> </ul>	<ul style="list-style-type: none"> <li>• Sheth and Pattawar (1995)</li> <li>• Doney and Cannon (1997)</li> <li>• Kuenzel and Krolikowsaka (2008)</li> <li>• Davison et al. (1984)</li> <li>• Iyer (1998)</li> <li>• Lennox and Park (2007)</li> </ul>	<ul style="list-style-type: none"> <li>• Relationships</li> <li>• Trust</li> <li>• Loyalty</li> </ul>	<ul style="list-style-type: none"> <li>• Extends existing relationships theory offering additional insights in the context of auditor selection in the FTSE 350 – the influence of cross directorship and alumni relationships is variable</li> </ul>
3. Service definition is not static, it evolves as value is co-created	<ul style="list-style-type: none"> <li>• Comprehensive view of service design</li> <li>• Evolving consideration of service</li> </ul>	<ul style="list-style-type: none"> <li>• Traditional selection models (e.g. Huang, 2007; Ho, 2010)</li> <li>• Vargo and Lusch (2004)</li> <li>• Payne et al. (2008)</li> </ul>	<ul style="list-style-type: none"> <li>• Static utilitarian models</li> <li>• Service Dominant Logic</li> <li>• Co-creation of value</li> </ul>	<ul style="list-style-type: none"> <li>• Challenges traditional models with transaction based value constructs</li> <li>• Supports and extends co-creation of value in the auditor selection situation</li> </ul>
<b>Other contributions to knowledge</b>				
1. Supporting competency based surrogates for service confidence but highlights competences tested not reliant on word of mouth. Capabilities can be negative	<ul style="list-style-type: none"> <li>• Competences on three levels</li> <li>• Desire for knowledge and specialist expertise</li> <li>• Industry and technical</li> <li>• Geographical coverage and accessibility</li> <li>• Industry and non-audit service conflicts</li> <li>• Lack of influence of word of mouth</li> </ul>	<ul style="list-style-type: none"> <li>• Almer et al (2013)</li> <li>• Beattie and Fearnley (1995, 1998 a and b)</li> <li>• Hermanson (1994)</li> <li>• Sands and McPhail (2003)</li> <li>• Scott and van der Walt (1995)</li> </ul>	<ul style="list-style-type: none"> <li>• None explicit</li> </ul>	<ul style="list-style-type: none"> <li>• Supports and extends existing research to the FTSE 350 in the period 2001 to 2012, challenges role of word of mouth and updates to reflect regulatory developments</li> </ul>

Table 29: Summary of contributions to theory and knowledge

### **A conceptual model of FTSE 350 auditor selection**

Utilitarian theory exemplified by previously referenced Rational Choice Theory (O'Shaugnessy and O'Shaugnessy, 2005) would suggest that an auditor selection decision ought to be driven by identifying and pursuing the most valuable outcome. The traditional supplier selection literature attempts to do this by identifying criteria of importance (normally including quality, delivery and price) and then modelling outcomes which maximise utility against these criteria. The current research has identified that this was not happening in the research period in relation to auditor selection and so challenges the application of such economic theory to auditor selection. Findings related to the relative unimportance of fees to the final decision provide further support for this.

The conceptual model presented illustrates that in the complex auditor selection context (as explained in Chapter 1 and considered within the literature review in Section 2.5) those selecting auditors are not identifying, ranking and modelling desired decision criteria. Rather, given the presence of intangibility and uncertainty, they are using a combination of considerations to come to a final decision.

These considerations include past relationship influences as has been observed in the professional services literature set out in Section 2.4 (see for example Perner, 2013) although, as will be set out in the next claim to contribution, these influences appear to be operating in a complex way for auditor selection), dynamic service design (as set out in third contribution below) and the capabilities and competences of the firms and their teams. Each

of these areas is modified by behaviour during the selection process, which is also a decision influence.

In assessing their auditor selection decisions this research has identified some evidence which supports heuristic theory and intuitive decision making (Kahneman et al. 2007; Kahneman, 2011)(for example in the focus and emphasis placed on recent experience identified in Phase 1) but auditor selectors do not seem to be satisficing (Simon, 1997), at least not in their final decision making. The research therefore challenges the operation of bounded rationality in this context. As set out in Section 7.1.1 there are (at least) four firms, all of which could adequately conduct an audit for FTSE 350 companies and yet companies still invest substantial resources into auditor selection decisions.

Finally the substantial and varied behavioural influences identified provide some support to the work of Payne et al (2008) in this different context by highlighting the importance and variety of influences created by “encounters” in purchase decisions. As noted in Section 2.3.3, Payne et al. (2008) suggested different purposes for activities supporting decisions in “encounters”. These included “emotion supporting”, “cognition supporting” and “value explaining”. Similarly the current research identifies elements of relationship and behavioural influences, service design and capability assessments (which might be aligned to value definition and explaining).

### **Relationships are contextual and based on compartmental view**

There is considerable literature setting out the influence of relationships in supplier – purchaser relationships. These include economic benefits (see for example Sheth and Pattawar (1995)) and more intangibles such as trust (Doney and Cannon (1997) and loyalty (Kuenzel and Kowlikowska, 2008) . In the specific auditor context the positive influence of cross directorship relationships (Davison et al., 1984) and economic benefits provided by alumni to their former firms has been posited (Iyer, 1998; Lennox and Park, 2007).

The current research extends our understanding of the complexity of relationship influences in auditor selection. The longstanding audit relationships highlighted in Chapter 1, seemed to indicate the potential importance of trust and loyalty however this research (especially Phase 1) supported the previous work of Beattie and Fearnley (1995) that tenders were often associated with dissatisfaction which in turn was consistent with high switching rates . This research has however also extended the work of Beattie and Fearnley and (especially in Phase 2) highlighted the inherent disadvantages faced by incumbent auditors. In an environment of increasing corporate governance and greater willingness to embrace change, the attractions of a fresh look and other influences related to a new auditor meant that an existing relationship might be a factor against an ongoing relationship. Mandatory audit firm rotation has codified change since the study was completed (see Section 7.4.2).

The current research does not deliver a general challenge to the operation of trust and loyalty. Indeed the evidence of the positive influence of a track record of delivery in other services or at other companies provides some evidence of their operation.

The study does however challenge the presumption of a positive influence of cross directorships and alumni relationships (Davison et al., 1984; Iyer, 1998 and Lennox and Park, 2007). Across the three phases such relationships were not consistently positive, rather they may be also be neutral or indeed negative given the individual context.

**Service definition is not static, it evolves as value is co-created**

The traditional supplier selection literature set out in Section 2.1 and referred to previously in this section typically involves highlighting important decision criteria and then maximising utility against those criteria in a transaction or set of transactions (See Huang, 2007 and Ho, 2010). Most of the auditor selection literature discussed in Section 2.5 and summarised in Appendix II uses a similar approach; namely potential criteria are identified or proposed and questionnaires sent to consider the importance of each criterion to the decision.

This research however challenges these static and transaction based theories and approaches. Even in the highly regulated and prescriptive auditor selection situation (as described in Chapter 1), the research identifies evidence of firms testing their ideas and propositions and in turn companies assessing and also testing these ideas and propositions. Supporting previous service

selection literature (e.g. Ellram, 2007 and 2008) companies are not prescribing precise upfront definitions. In the context of typically extensive auditor selection decisions, firms and companies are co-creating the audit service with potential auditors which supports the operation of Service Dominant Logic (Vargo and Lusch, 2004) in this context.

This is a particularly interesting insight in this context. Firstly the core audit is prescribed by law and regulation, secondly the wider service relationship is heavily confined by regulations tightly restricting the provision of non audit services by auditors and thirdly the auditor selection is still a long term purchase where selection decisions take place only infrequently and so precise service requirements can't be known. It is therefore an interesting additional insight that even in this environment companies and firms are still co-operating to create service designs and working relationships.

### **Supporting competency based surrogates for service confidence**

As previously noted in Section 2.5, the importance of capability and competence assessments has been widely identified in auditor selection literature and (as highlighted in Section 2.4 ) professional services supplier selection literature. See for example Beattie and Fearnley (1995) and Sands and McPhail, 2003). This is perhaps unsurprising given the expert nature of the services being purchased.

A further contribution of this research is to confirm the importance of such factors in FTSE 350 auditor selection but also to extend this work to highlight competency assessment operating at three levels; the lead partner, the team and

the firm (supporting the recent work of Almer et al, 2014) and in different ways at each level. This research also highlights that companies assessments of competences can change through the proposal process which typically involves testing the firms. There is little evidence of reliance on word of mouth challenging previous literature (e.g. Reingen and Kernan, 1986). This research also updates previous auditor selection studies reflecting the changes in regulation that have occurred as identified in Chapter 1 Whereas earlier studies for example Beattie and Fearnley (1995) highlighted the importance of the capabilities of potential auditors to provide other services, this can now be seen as a negative influence on selection as access to this capability would be banned should the firm be appointed as auditor.

### **7.2.3. Contributions to practice**

In addition to these contributions to theory and knowledge the research is also informing practice at an important period with more frequent tendering following associated with the regulatory developments previously explained. The principal contributions have been as follows:

1. Informing the Big 4 firm – the results from the research formed the basis of the firms' methodology for winning new audits and support ongoing coaching on major audit proposals.
2. Supporting the regulator (The FRC). This researcher discussed the findings of this research with the FRC and contributed to two of the three round table discussions chaired by it following the issuance of the September 2012 corporate governance code. These roundtable

discussions involved senior members of the FRC, institutional investors, audit committee members, investors and leaders of the Big 4 and Mid Tier firms. Subsequently this researcher supported the FRC in their preparation of best practice material to assist companies with their tenders.

3. Aspects of the findings from proposals identified by the research have been widely disseminated by this researcher with those tasked with overseeing and managing FTSE 350 audit tenders. To date discussions have taken place with almost 100 officials of those companies.

### **7.3. Implications for theory and practice**

The lessons from the research provide a model to increase awareness of the auditor selection decision which will inform both buyers of audit services, those providing them and others such as regulators.

As previously identified the presence of each of the factors in the interviews and interview records (with the exception of the dynamics of final decision making in Phase 2b as discussed above) was very high (over 90%) in all three phases.

#### **7.3.1. Implications for theory**

The current research has developed a conceptual model of auditor selection for FTSE 350 companies. It identifies the need for a holistic approach which considers a broad range of factor groups and their interplay in a dynamic intuitive process which, even in a very high profile decision does not follow



rational choice theory. This has implications for supplier selection in procurement and for decision theory as the next two subsections explain.

### **Supplier selection**

The conceptual model recognises complexity in the auditor selection decision which is consistent in nature with holistic multi-faceted approaches previously suggested in established organisational buying behaviour literature (Webster and Wind, 1972) but not previously applied to the auditing context.

The complexity associated with the multifactor conceptual model integrates Service design and Capabilities and competences assessment with relationship and behavioural influences on decision making

Although constructed for the auditor selection decision in the UK FTSE 350 the model may have implications for other complex selection decisions especially other professional services. Whilst the specific context of the auditor selection decision is recognised and in particular those specificities related to public profile and regulation; similar influences may well underlie other purchases in for example legal and consulting services.

The different circumstances applying in different jurisdictions are also recognised but the application of such a holistic conceptual model might also extend our understanding of auditor selection in other markets and contexts.

### **Decision theory**

There is very extensive previous research which looks at decision influences. This includes:

1. Literature setting out normative economic theory including for example Von Neuman and Morgenstern (1947) and its potential value in decision making (Fischhoff et al., 1981).
2. Behavioural decision theory which challenges the application of economic theory in practice; including notably Ramsey (1926), Simon (1997), Savage (1954) and Kahneman and Tversky (1979).
3. Affective and relationship influences generally (for example Sheth and Parvitiyar, 1995). Andersen and Kumar, 2006), and specifically relationship influences such as trust (Doney and Cannon, 1997), and loyalty (in professional services; Kuenzel and Krolikowka, 2008).
4. Lastly the influences of interaction at a group (Asch, 1951) and broader societal level (Etzioni, 1988).

The current research has identified that in the specific context and complexity of the auditor selection decision that companies do not generally appear to be using algorithms based on economic theory. Moreover fees were not seen to be very influential in the decision for reasons including that they were identified as being negotiated after a decision had been made. There were however results consistent with behavioural decision theory and aspects of relationship theory and group dynamics. In other words, these decisions seem

to be less logical/economically rational and more intuitive/emotional/affective than might be expected.

This is perhaps a somewhat surprising finding. In a high profile business purchase it might be expected that underlying economic considerations would play a dominant part. Yet it appears that even in the context of a high profile decision, behaviours rather than economic theory may be determining decision outcomes.

This raises a broader question for decision theory. If a holistic model can contribute to our understanding in the specific auditor selection context, could this model be more generally applicable to other decision contexts. There may be potential for future research to apply the conceptual model in different practical contexts in similar ways to that applied in the auditor selection decision in the current research.

### **7.3.2. Implications for practice**

The conceptual model of auditor selection for FTSE 350 companies produced from the current research identifies a broad range of factors which those with recent experience of an audit tender considered in coming to the selection decision. The findings of this research are relevant to companies faced with conducting an audit tender, auditors and regulators.

## **Companies**

For those considering an audit tender it provides an opportunity for them to consider these factors and how they may evaluate them in coming to their own decisions:

1. As identified in Chapter 1, the current and recent revolution in regulatory scrutiny over the Big 4 has been driven in large part because regulators and law makers feel that tendering will increase competition and, especially, audit quality. In designing their processes they may wish to consider how this is being built into the proposals and how they will assess it.
2. Also in relation to Service design, this research identifies the importance attached to constructive working relationships. Companies may wish to consider how they balance their desire for such relationships with associated personal chemistry, and cultural fit with auditor independence and objectivity.
3. Capabilities and competences assessment of the firm, the team and the lead partner has been identified as one of the five factor groups. The importance of the lead partner also seems to be growing if Phase 1 is compared to Phase 2. Companies may wish to consider how they are evaluating competence in particular. The current research identified that much of the comment about testing in this area related to the final presentation. Companies may wish to reflect as to whether that is really

sufficient and whether lessons could be learnt from other similar practice, for example recruitment practice.

4. The current research has supported and extended previous literature identifying the important influence of behaviour during a proposal process on the final decision. Some of this behaviour appears to be about testing and developing propositions however other behaviour seems to be mostly affective concerning general interaction and signalling by competing audit firms that they really care about winning the work. There is a challenge for companies to recognise these affective influences but to place them appropriately within proposal processes which are appointing auditors to protect the interests of shareholders.

### **Auditors**

This research suggests that auditor selection decisions taken by FTSE 350 companies can be complex and rely on contextual influences, important factor groups and the interaction between these factor groups. This would suggest that auditors seeking to respond to clients and potential clients ought to take a comprehensive approach starting from a position that each selection process is going to be different given the company's particular situation but then also:

1. Investing in establishing a track record of service delivery with companies but probably not relying on word of mouth influences and being cautious about alumni and current cross directorship relationships.

2. Taking a flexible approach to Service design involving a combination of proactive ideas testing and adapting and considering the different aspects of the delivery model including the core service, the facilitating services and the supporting services.
3. Planning carefully to identify Capabilities and competences to address companies' industry, technical and geographical needs, but also across the three levels of assessment identified during this research; namely the lead partner, the team and the firm. In addition firms should focus on the way that those Capabilities and competences are made available including for example dealing with potency at the lead partner level and potential conflicts at all three levels.
4. Recognising the importance of personal interaction and evidence of hunger and enthusiasm. The interactions in a proposal process being recognised as an important influence in their own right as well as influences on other factors; although perhaps not overly relying on this alone given the discussion under Behavioural influences during the process in Section 7.1.2 above.
5. Understanding the likely dynamics of the Final decision making; what is likely to be taken into account, who is likely to be most influential and the likely nature of the interaction. This latter consideration involves weighing up carefully the roles of management who have most contact with the auditors and the audit committees with responsibility for auditor appointment and retention.

## **Regulators**

For regulators seeking to promote audit quality, there would appear to be opportunities to promote better understanding of the influences affecting auditor selection by encouraging debate between Audit Committees and others involved in these processes.

Given the complexity identified by this research, there would appear to be potential benefits in promoting comprehensive debate about how future selection decisions might be organised so as to support the improvements in audit quality that are being sought. The current research would suggest that this ought to consider each of the factor groups influencing auditor selection.

## **7.4. Limitations and opportunities for future research**

### **7.4.1. Research limitations**

The first limitation of the study related to the quality of the data analysed as Phase 1 of the research. The interview records of the Big 4 firm were created following post decision proposal reviews conducted by members of the firm's staff who were independent of the proposing teams they could necessarily only relate to the proposals that that firm was involved in. In addition the quality of the notes was variable. Although some were comprehensive others were quite short. The interview records, obtained with the permission of the firm, however provided some eight years of valuable data on FTSE 350 audit proposals. In terms of the research approach, these interview records provided very valuable

background and enabled the preparation of an initial conceptual model which stimulated thinking and highlighted potential themes and ideas.

The final conceptual model was however created following two further independent phases of the study. These two phases contained 47 interviews considering both buy side and sales side perspectives and either recorded or subject to detailed cross checked interview records. The final conceptual model therefore is not reliant on Phase 1 although the extent of data provided a useful background and cross check against it.

The second limitation related to the exploratory nature of the research. Given the paucity of literature in relation to auditor selection identified by the research, the study was designed to identify the factors affecting auditor selection. It was not focussed on investigating the specific influence of any one individual factor its weight or the nature of the inter-relationships between factors (although some interesting indications of inter-relationships have been identified and included in the conceptual model). There is an opportunity for further interview based research to explore these aspects specifically.

In developing the research design, consideration was given to adopting an approach using the repertory grid technique which explores an individual's ways of looking at the world or personal constructs (Kelly, 1955) by exploring what is important to the interviewee in relation to an area under investigation and making comparisons between constructs. Whilst this is a powerful technique it relies on interviewees being able to make comparisons between equivalent decisions. In the current research, the majority of those involved would only



have participated in a single decision. This technique was therefore eventually discounted for the current research which adopted semi-structured interviews which (for all the reasons set out in Chapter 3) were considered an appropriate method and which were also consistent with standard practice in the industry for obtaining post decision review feedback. There are however still opportunities for future research to use this techniques, for example with audit firm partners who have been involved in multiple decisions.

In addition because of the dynamic nature of the decision and the identified importance of behavioural influences there are opportunities to further explore the decision with more observational or ethnographic research techniques. One of the ways that the behavioural aspects of auditor selection might be explored further is through an ethnographic (pioneered in anthropology – for example Malinowski, 1935) or an even an action research approach. This would involve participation by the researcher in auditor selection process, where the interaction and behaviour of both the companies and the competing firms could be observed or even the process facilitated. This is potentially being made more feasible because of the regulatory changes identified above. One of the features of impending mandatory audit firm rotation is that the incumbent auditor will no longer be allowed to participate in audit tenders. In addition in some proposals a firm providing non audit services has either declined to propose or been excluded from the process. In some cases companies have turned to their auditors or the firms otherwise excluded for advice as to how to run a tender process and in isolated cases members of these firms have sat in as non-voting participants in the selection process; including

the final presentations. The precedent for external observation of audit tender processes has therefore been set.

One specific area of the decision making process which was a limitation for this study was the Final decision making discussion where the post decision semi structured interview based approach did not fully capture the final dynamics of the interaction of those involved even though it was explored in the interviews conducted. This could only really be fully achieved by observational approaches either by researcher presence at the final discussion or potentially by the use of video if this was considered less intrusive.

#### **7.4.2. Recent regulatory developments and the practical application of the conceptual model**

In addition to the research limitations affecting this study, and in the fast moving nature of regulation which was explained in Chapter 1, there have recently been developments which are likely to influence the application of the research to practice in the future.

Since the end of the research period regulatory change has continued and there have been a number of developments. These are summarised in Table 30.

Legislation/regulation	Principal impact on auditor selection
<ul style="list-style-type: none"> <li>UK Corporate Governance Code, issued by the Financial Reporting Council (“FRC”) 30 September 2012 (effective 1 October of that year).</li> </ul>	<ul style="list-style-type: none"> <li>FTSE 350 companies should put their external audit contract out to tender at least every ten years or explain clearly why they haven’t done so that subject to certain transition provisions) (FRC, 2012, paragraph 3.17 page 19. See also page 4 re Comply or Explain).</li> </ul>
<ul style="list-style-type: none"> <li>UK Competition Commission (“CC”) final report on investigation of the market statutory audit services for large companies in the UK (CC, October 2013).</li> <li>UK Competition and Markets Authority (“CMA”) proposals following introduction of new European Union legislation (CMA&lt; July 2014) (effective 1 January 2015)</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory audit tendering for FTSE 350 companies at least every ten years and additional disclosures in annual reports where a tender has not been held for more than five years (subject to transition provisions and currently September 2014 subject to further consultation)</li> </ul>
<ul style="list-style-type: none"> <li>European Legislation (June 2014) (effective June 2016)</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory audit firm rotation every ten years for Public Interest Entities in the European Union ( including FTSE 350 companies) which may be extended to 20 years if a competitive tender has taken place (subject to transition provisions which mean it is effective for most companies either in 2020 or 2023).</li> </ul>

Table 30: Certain relevant changes in law and regulation since the end of the period covered by the research

By requiring more frequent audit tendering and periodic mandatory firm rotation these changes will significantly increase the level of audit tendering in the coming years such that the process is very likely to change and evolve as companies and audit firms develop their approaches and lessons are learnt about best practice in audit tendering.

The new regulations will especially affect the nature of the relationship with an incumbent auditor. In some cases that auditor will have reached the end of their permitted term and be excluded from the process. There will also be more cases where a tender is being conducted following regulation against the backdrop of a positive relationship between a company and its incumbent auditor. This changing dynamic provides opportunities for future research although given the changing landscape and because the most far reaching

changes associated with these new regulations do not come into force for most companies until 2020 or 2023 it is perhaps too early to assess what their impact might be on auditor selection at this stage.

In addition the new regulations have been introduced with an aim to improve audit quality; responding to the events highlighted in Chapter 1. It is not clear whether more audit tendering will achieve this especially given the findings of this current research which identified audit quality as only one factor influencing auditor selection among many, and as part of a much more complex decision consideration. Future research might investigate whether the new regulations have achieved their aim. Given the difficulties identified in relation to credence goods (Darby and Karni, 1973) this will require greater understanding and transparency about what constitutes audit quality and that poses challenges both for theory and practice.

## **7.5. Conclusion**

This study has been organised to answer the research question:

*What are the factors affecting the auditor selection decisions made by  
FTSE 350 companies in competitive tenders?*

It has identified a complex decision process involving relationship, behavioural, capability and service design elements all feeding into final decision making. The conceptual model produced offers a holistic solution to the research question including each of these factors and also suggests the nature of the principal interactions between them. This has extended our

understanding of auditor selection and offers insights which are likely to be relevant for other complex purchasing decisions; such as those in other professional services.

The research has also extended our understanding of the influence of relationships in auditor selection and challenged certain previous research concerning the influence of cross directorships and alumni.

In addition the research supports a dynamic service design process which supports more recent supplier selection literature and service dominant logic and challenges the application of utility theory in this context.

Lastly the research supports the importance of capability and competence assessment in auditor (and professional services supplier) selection and provides additional insights into how this is taking place.

The study has taken place in a period during which the auditing profession has changed significantly; since the emergence of the Big 4 following the demise of Arthur Andersen in 2002. Greater regulation and more recently new legislation and oversight have intervened into the relationship between a company and its auditor. Greater pressure for audit tenders and the rotation of audit partners, and now audit firms, is being encouraged and required in the interests of greater competition and improved audit quality. This makes the current research particularly timely for practice.

The current study however provides mixed messages for those promoting audit tenders and audit firm rotation in the interests of improving audit quality

and expanding choice beyond the Big 4. The comprehensive and competitive nature of proposals and in particular the co-development of new ideas and approaches which has been identified would seem to support an environment of improving service quality. And auditor tenure periods will shorten. However given the views expressed by those interviewed about the competences of the Big 4 and their people compared to other smaller firms it seems most likely that tendering will result in moves between the Big 4; rather than outside that group. Whilst the current research provides considerable insight into how auditor selection decisions are made, it is unclear that future changes will result in a wider population of non-Big 4 firms serving FTSE 350 companies.

A further implication of these findings is that those promoting tenders may be underestimating the nature and extent of the network of relationships that exist between the Big 4 and FTSE 350 companies. This research has identified a range of relationships going well beyond the company and its incumbent auditor (including past service relationships). This makes auditor rotation in practice more difficult. Perhaps even more importantly they may also be underestimating the influence of behaviour during a proposal process, including the personal connections that are established. The current research shows this to be an essential component of the decision. A key finding is the strong role that interaction/experience and personal connection play; this in turn suggests that proposals may well promote the appointment of those who are adept at this rather than necessarily giving rise to audit quality improvements. This has considerable implications for regulators as well as for companies and their auditors.

Whether increased proposal activity will improve audit quality or encourage a profession focussed on relationship building and salesmanship, the next few years will discover.

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## APPENDIX I

### PROFESSIONAL SERVICES SUPPLIER SELECTION CRITERIA THEMES (EXCLUDING STATUTORY AUDIT)

Author	Market/ Location	Method/ Sample analysed	Relationships	Findings		
				Competence	Behaviour	Service
Cagley (1986), Cagley and Roberts (1984)	US advertising	Questionnaires to 125 advertisers and 192 agencies		Reputation of teams and firms Quality of people Integrity	Learning about the business	Agreement of goals and objectives
Dawes (1992)	Management consultancy Australia	Questionnaires from 253 buyers of consultancy	Client knows firm or consultant from previous work	Reputation of teams and firms Industry knowledge Size, age and location of the firm less important	Proposal document and presentation	Assisting with implementation Fees
Day and Barksdale (1992)	US architectural, engineering and construction consulting	Questionnaires and follow up discussions 20 firms and 17 buying organisations		Experience, expertise and competence	Understanding clients needs Relationship and communications skills	Agreement on goals and objectives Contractual compliance/fees
Day and Barksdale (2003)		Questionnaires 147 organisations (NB included both public and private)		Relevant experience of the firm, team and project manager	Trust is built based on personal chemistry which itself can be critical	
Glucker and Armbruster (2003)	Management consultancy in Germany	Analysis of secondary data	Experienced based trust	Reputation		Competitive price
Somnez and Moorehouse (2010)	UK training	309 on-line questionnaires		Real world experience Capacity Industry knowledge	Challenges thinking Gravitas Individual assessments	Training design meets client needs Effectiveness Added value/cost
Stock and Zinszer (1987)	US logistics consulting	Questionnaires 270 buyers	Past track record with firm	Reputation of teams and firms (project specific, general, industry)	Professional behaviour associated with quality service	
West (1997)	US Advertising	Semi-structured interviews with 10 buyers	Trust	Quality of people Relationship skills	Understanding client needs Sharing information Cooperation	Willingness to adapt

## APPENDIX II

### AUDITOR SELECTION LITERATURE THEMES

Author	Market/ Location	Method/ Sample analysed	Themes			
			Relationships	Competence	Behaviour	Service
Adams and Davis (1994) Adams et al (1996)	CEOs of US private companies	225 questionnaires	Personal relationships	Technical strength of team Industry experience of team	Oral presentation quality	Fees
Adams and Allred (2002)	CEOs of US private companies	102 questionnaires CEOs	Personal relationships	Technical strength of team Industry experience of team		Fee not the most important
Almer (2014)	Audit committee members of US public companies	80 questionnaires and three semi-structured interviews	Alumni and other existing relationships a negative influence	Range of services Firm's industry and technical expertise Lead partner's ability to identify issues		Accessibility of lead partner
Baldacchino and Cardona (2011)	Newly registered companies and auditors Malta	68 questionnaires from companies 33 questionnaires from firms	References	Industry experience	Establishing a good relationship Understanding the business Personality	Quality of service Availability Service meets needs Long term relationship Value for money
Beattie and Fearnley (1995, 1998b)	CFOs or Company Secretaries of UK Public companies generally and those which had changed auditor	210 questionnaires from listed companies (1995 and 1998) In addition 118 questionnaires from companies which had changed auditor (1998 only)		Integrity of the firm Technical competence of firm, lead partner and team Good reputation Ethical standards of lead audit partner		Working relationship with audit partner(s) and staff Audit quality
Beattie and Fearnley (1998a)	CFOs of UK listed companies which had conducted a tender or changed auditor	12 interviews		Availability of non audit services		Decisions not based solely on price Audit quality Quality of working relationship
Eiechenscher and Shields (1983)	CEOs of US SEC registered companies who had changed auditors	81 questionnaires				Fees Working relationship (responsiveness and accessibility)
Hermanson et al (1994)	US Big 8 clients	Longitudinal study with four questionnaire surveys		Reputation Personal Industry experience		Fees relatively less important for large companies
Sands and McPhail (2003)	Company Secretary or equivalent of Australian listed companies	143 questionnaires		Technical competence Range of services	Quality of proposal	Client orientation Reliability and courteous accessibility Perceived quality of service Fees
Scott and van der Walt (1995)	Clients of a Big 6 firm in New Zealand	189 questionnaires based on criteria developed through qualitative interviews		Reputation for fast efficient service Specializes interest areas Expertise		Accessibility of key staff Ability to offer a personal service Fees

### APPENDIX III: INTERVIEW PROTOCOL

#### Interview details (to be completed pre interview) as far as practical

Personal Details	Role	Interview Details
1. Name:	2. Company:	3. Date and time of Interview:
4. Age (years) and sex (M/F)	5. Position and years in role:	6. Address for interview:
7. Nationality:	8. Role in the Proposal:	9. Contact Details (preferred):
10. Education and career history:	11. History with other audit proposals (if any):	12. Communication history (pre communication etc):

#### Proposal details (to be completed pre interview as far as practical)

Process (key dates and deliverables)	Company People	Firms Involved
13. Invitation to tender/request for proposal:	14. Selection panel:	15. Incumbent firm(s)
16. Meetings held/access given:	17. People firms met and contacted during the process:	18. Shortlisted and successful firm
19. Document(s) submitted and Presentation(s) received:	20. Document(s) and presentation(s) recipients	21. People involved and firm if known:
22. Decision meetings/dates:	27. People in the decision meeting:	

## **Introduction**

- Thank you for agreeing to take part in this interview. I appreciate you taking time out of your busy schedule
- This interview forms part of research being undertaken as part of my PhD at Cranfield University. Any comments you make will be kept confidential. Anything that is published in the thesis or academic publications will always be unattributable,
- The purpose of the interview is to:
  - understand your perspective on the recent audit proposal completed by your organisation
  - explore a number of specific factors and their importance (which I'll explain later)
- The interview is being taped and I may use the specifics in my PhD but they will be always remain unattributed
- Clearly you can choose not to answer any of my questions and indeed stop the interview at any stage if you feel that you want to
- I expect the interview to last about an hour
- Does all that seem ok with you?

## **Identifying/objectives and needs**

1. Can I start by asking you to talk me through the background to the tender?  
Potential Prompts:
  - What was the background to the proposal
  - What caused it
  - What were the needs that were to be addressed
    - Specific areas of service?
    - Best Practice
    - Fees
  - What were the selection/assessment criteria set at the start
  - Which were most important and why?
  - How did everyone feel about them? (Interest? Motivation?)
  - How important were they to the proposal?

## **Exploring factors affecting the decision**

I'd now like to explore the factors that affected the decision.

2. What do you think were the most important factors affecting your auditor selection decision?

Prompts: Exploring the factors generally:

- Which were most important and why?
- Who were they important to?
- What was it about each that was important?
- What was their relative importance?

3. To what extent were the various factors significant to the decision?

Prompts: Consider:

- Individual and firm competence factors?
  - Experience of the competing teams or firms – industry/sector?
  - Approach proposed?
  - Reputation? References?
  - Fees
- Relationships?
  - Trust?
  - Liking/personal chemistry?
  - Personal loyalty?
- What was experienced during selection?
  - Interaction in meetings/generally?
  - Documents presented?
  - Presentations given?

## **Decision making**

4. When did the decision take shape?
5. Which elements of the tender process affected the decision?
6. How was the decision made?
7. Who was involved and what was their role?
8. What was the relative importance of relationships, competences and performance during the process?

## **Conclusion**

9. Lastly – if I ask you to reflect – is there anything that you feel to be very significant about the selection decision that we haven't talked about or that you would wish to expand?

**Many thanks**

**APPENDIX IV:**  
**EXAMPLE OF A PAHSE 2a INTERVIEW TRANSCRIPT**

**Company I – Interview with Finance Director**

**Notes from a Post Decision Review on 12 January 2011**

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**Attendees:**

<b>Finance Director</b>	<b>FD</b>	<b>Company I</b>
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<b>Philip Drew</b>	<b>PD</b>	
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*NB the ethical clearances including agreement to use the interview for the purposes of research were in this case obtained prior to the meeting.*

**Um I guess it works best if I just say are you happy to take it from the top and just tell me the story from your point of view because that way I guess you'll talk about what you thought was most important to you rather than bombarding you with a lot of questions?**

**Absolutely, no I will.**

**And I'll just sit and listen and chip in if I may if that suits you?**

**No I'll do that**

**I should say at the outset that I saw [previous Finance Director] after the last one [tender conducted by the company].**

OK, OK (laughter)

**Which was about what 6/7 years ago.**

A time ago...

**I think things have moved on a bit since then.**

I mean the first thing to establish is why did we put the audit out to tender in the first place.

**Yes**

And that was, that was mostly because for the last 2 or 3 years we'd become increasingly dissatisfied with [INCUMBENT FIRM].

**Right**

And we'd become dissatisfied with them because of the audit approach that they've taken and the fact that increasingly it was obvious to us that the work that they were doing to mitigate the risks that they said were evident in the business, the additional work was giving them any comfort. So they were unhappy that they could rely on the IT systems so they were essentially testing quite large numbers of transactions in terms of audit testings, testing 50 transactions and doing quite a bit of work and doing system walk throughs. But we do millions of transactions a month so the level of comfort ....

**50 a second or something probably?**

[Laughter] After years of doing this stuff we just began to think that they were, that they were just mistaken and there must be a better way

**Right**

to do the audit so, we challenged them on that and they gave us an IT remediation plan

**Right**

to complete and at the end of that they then said they would rely on the systems and controls, the IT systems and controls

**Right**

So they did the remediation and they, at the end of that said that it was **almost** satisfactory but not quite, so they could rely upon it and that sent the [CHIEF OPERATING OFFICER “COO”], who’s quite a powerful figure, senior figure that sent him into a real tailspin.

**And from your point of view you’d done everything...**

Yes and it was embarrassing for the previous Finance Director because he had said look [COO], I’ve got the solution to this it solves my problem, you do this work, the auditors are happy, the non-execs will be happy, the Audit Committee will be happy, I’ve got the solution so we did the work and at the end of it, they just at the last minute they pulled the prize away so that irritated them monumentally

**Yes**



And that was the kind of, the straw that broke the camel's back and we decided to, given the support we felt we were receiving at partner level which was, non-existent, almost non-existent, given the value add, given the expense of the audit, given the approach that there was more than enough there just to put it out to tender, just to see if anyone could do a better job.

**Right**

And it turned out that all the three firms that pitched could evidently do a much better job than the service we were receiving and I say that because [FIRM A] were miles better, [FIRM B] were much better than the service we were getting and [INCUMBENT FIRM] replaced the people on the audit and served up a new team and they were much better.

**Right**

Umm so, through the audit process we put out the challenges, how would you audit this IT business, um what comfort would you need, um and how would you add value to us in doing the audit?

**Right**

Obviously you're not, the auditor isn't our servant but it's very useful to get opinion from an industry expert who's seen lots and lots of different companies and it can't obviously all be one way I mean we're very happy to spend time developing your business like in this call but we'd like a bit back and it doesn't mean being on the phone for hours and hours just means answering simple

questions with reasonably straight answers when you can, when confidentiality allows.

**Yes**

And we didn't have that kind of healthy relationship with [INCUMBENT FIRM] we were looking for that.

**Right**

So we set, set quite an um defined process for the proposals.

**There were some factors [in the ITT], you know was that the whole story?, You know I guess there were half a dozen points you sent out in the ITT was that everything? How much thought was behind it.**

Oh plenty because we still regard our business as quite a small business so the, most of the execs have been here for at least 10 years and they're very hands on, very operational and they can, within a couple of hours we can set down exactly what we would like

**Right**

And it's all just come through the process of...it did help having the document that you guys highlighted but saying the actual specific things if you like

**Yes**

We know exactly what to say, it did help having the [FIRM A audit tendering guide]. I had two I had one from [FIRM B] and one from [FIRM A] and they were both very helpful.

**I suspect they're similar too?**

They're very similar, it's good common sense and it's a good discipline and I would say that that was very useful in the process because it just gave us the discipline to put everything in a, in boxes in the right order and then the specifics of what we were asking for we were really clear about.

**Right**

We didn't want to be deluged with data and information, we wanted to keep it quite high level and we wanted certain particular things answered in any proposal and obviously we put IT at the heart of it because it was the IT problem in the first place that caused a bit of a bust up.

**Right**

And it was the approach that [INCUMBENT FIRM] were taking to IT which was dictating the audit approach which meant we had 6 or 7 juniors out here doing work that none of us in financial control or risk could deem would have any value at all.

**You didn't understand why they were doing it?**

Could not understand and they couldn't explain why they were doing it either when challenged no one at [INCUMBENT FIRM], the only response we

could get is we need it because we can't place reliance on the controls. So a bit frustrating because you couldn't really place reliance on testing 50 transactions out of 48 million when the risk is that someone will go in and overwrite one of those transactions for us to get them out.

**Right and did all of the three firms come back with a plan that addressed that?**

Yes they did, they basically went um past where we'd got to with [INCUMBENT FIRM] so [INCUMBENT FIRM] said do the remediation and then we can rely on the controls and then we drew that at the last minute because there was one system where we can't do remedial work because the operating software does not allow that.

**Right**

It would need to be upgraded so what we're doing is we're planning to get off that system so every single one of the firms that proposed looked at the controls that we had and asked for us to put compensating controls around the areas, the one area that was weak and said that subject to those operating they could rely on the controls and they would do a controls based audit.

**Right**

And given the alternative is to do an audit that's (giggle) and you just add cost, very simple thing to agree to and [INCUMBENT FIRM] within a week of new people coming on board were agreeable to that.

**Right**

So our partner was rotating off so the partner that joined from [INCUMBENT FIRM] wasn't completely new to it but they all came along with this idea that they would rely on the internal controls subject to you know compensating controls over certain areas where we're weak.

**So in a sense within a week of going to tender you, you kind of had the solution to, at least part of the solution to the problem that was, that had started it?**

Ummn, yes

**Maybe only ...**

Yes we did only part of it because we didn't feel we were getting a great service from [INCUMBENT FIRM] period so there were other things that we wanted

**Right OK**

there was kind of the mood that given that they had been quite poor for so long they should be punished and we should try with someone else because its, it's kind of, we had communicated that we were a bit frustrated with the approach, we communicated a number of things, I kind of fed back to them and they had really addressed it um, and you have to be very forgiving to say OK well now, now we've kicked up all this fuss and kicked off all this work and you've agreed to change your approach so we've agreed to you know give you another chance and that would have been an easier thing for us in the finance

department to do and we did consider um, staying in bed with them but in the end the other firms and [FIRM A] especially did present a better team.

### **Right**

So the benefit of moving, in the end was actually quite small, not small sorry it was, was um, wasn't as huge as we thought it would be because we thought that after about three weeks it was obvious that the existing [INCUMBENT FIRM] team was very poor and both the firms would be miles better.

### **Right**

But at the end [INCUMBENT FIRM] pulled it round to such an extent it wasn't such a big gap.

### **OK. So having sent the ITT out what, what happened next?**

Ummn, a think it was generally agreed that, that [FIRM A] spent more time here and made a greater effort than anyone else to understand the business and talk to people so ummn obviously if they hadn't have got the appointment it would have been work hours wasted. Ummn, it's pretty clear and I think it was universally fed back that they'd probably spent nearly, nearly twice, but definitely 50% more time here than [FIRM B] did and [FIRM B] made a pretty solid effort I guess in the work, they really wanted the work so the process kicked off, it was done very well I think the guys done, it was obviously the leader in [FIRM A LEAD RELATIONSHIP PARTNER] that made it so that it was very light impact because of the spread around, they just went to see people

they weren't accompanied, didn't need to be and they just you know, put their head around quite a few doors, spoke to everyone, more or less universally I got positive feedback. I didn't get it from everyone on every occasion but I didn't get that for [FIRM B] or for [INCUMBENT FIRM] who reintroduced themselves but you know, 90% of the time very positive feedback

**Right**

Relevant and useful meetings with the people and the guys did all their information gathering and we went to the point of sending in the proposals.

**Right and was it, kind of led you a bit because I said what happened when the ITT came in but I just wondered, there were obviously a...**

When you say the ITT you mean...

**The invitation to tender...**

Oh yes, yes sorry yep

**There was obviously a period between you thinking that you might go to tender or even with that in your mind and the thing coming in and you know the various firms had relationships with you before you had an issue with the tender, to what extent, apart from the service issues that you mentioned with [INCUMBENT FIRM], to what extent were the previous relationships that you had through various services and knowing people over the years, how significant was that to the whole thing?**

Ummn...

**I guess [FIRM A LEAD AUDIT PARTNER] had known you for I don't know 6 months or something like that?**

Less than that, I think, I think the previous finance director was signalling to the other firms to people that there was the possibility that the audit would go to tender

**Yes**

Because I think he would have liked...you know we should have done it maybe a year ago but it was anyway it was well signalled that we would go to tender

**Right**

So I think some of the...[FIRM A LEAD RELATIONSHIP PARTNER] would certainly have been on notice and the guy at [FIRM B] would have been on notice [FIRM B LEAD RELATIONSHIP PARTNER]

**Right**

So those guys were kind of notice and you know wait to hear. I know the people at [FIRM B] because I actually was trained in the financial business unit which is the unit that does all [RELEVANT INDUSTRY SECTOR] audits so I think if we were going to go tender, naturally because I know that group and because they'd been tipped anyway

**Yes**



Naturally we would have included [FIRM A] because it's a good firm and [FIRM A LEAD RELATIONSHIP PARTNER] did a...the extra mile in that when I, because I'm doing this post as an interim, so when I started as interim having been out of finance for, for not having been in finance since what for 10 years and having just done [DIFFERENT ROLE] since then and then sales and other things, he put me in touch with [FIRM A LEAD AUDIT PARTNER] and said would you, you know [FIRM A LEAD AUDIT PARTNER] would do like a refresher of, kind of FD refresher and that was really useful for me and obviously that, you then build a relationship with someone in the audit side of the firm

### **Right**

So I mean there was as much, obviously there was something in that for [FIRM A], there was something in it for me, absolutely from my perspective I kind of bit their hand off at that offer because a very, very useful offer.

### **Right**

So it gave us, it gave [FIRM A] a relationship with the new FD, it gave them the opportunity to introduce me to some of the people there and obviously as an FD you're a buyer of services and it's good to have that professional network and the people were very good, they were very impressive. So I had exposure to those two channels and obviously [FIRM A LEAD RELATIONSHIP PARTNER]'s exposure to [COMPANY I] goes back to the relationship on the tax side and the relationship that goes back quite a long way

**Yes**

So he was obviously, [CEO] kept him up to speed and I wouldn't be surprised if [CEO] asked him to, you know had a, see if he could arrange anything for me to help me into a new role where I was very unfamiliar.

**Right, so when you kicked off your proposal process, did you have any expectation of who you thought would win?**

None, no.

**Right**

We didn't, we didn't think that [INCUMBENT FIRM] would win; we absolutely thought they had no chance of winning

**Right**

And it actually come as a big surprise in the end that they actually came so far back from how we perceived them, I think after kicking off the tender process within about a week of seeing representations from the other two firms it was obvious they were so much better than what we were getting at the moment

**Right**

And it was only late in the process that [INCUMBENT FIRM] came back and actually looked very good.

**You mentioned that [FIRM A] spent more time round here, was there much or was there anything about the nature of the meetings that the firms were having that was different, you know was anybody talking about better, better issues or showing more understanding or was it just the question of just pure investment of time?**

Ummn, the feedback I got ummn, especially about [FIRM A LEAD AUDIT PARTNER] was very positive because he's very good at, he's a good listener ummn he often follows up points that are raised at the meetings

**Right**

which impresses anyone, ummn and, I think genuinely none of them felt like they were being sold anything which is the only criticism that came through from some of the other meetings, not necessarily the [FIRM A] meetings but sometimes the conversations in these things move towards other services that the firms sell.

**Right**

and obviously if you're there to talk about the audit, some people objected to that. That wasn't that's not kind of [FIRM A LEAD AUDIT PARTNER]'s style, that was the only criticism I got back about the meetings.

**Right**

Ummn, I think [FIRM A LEAD AUDIT PARTNER] and [FIRM A AUDIT DIRECTOR] their experience is pretty relevant for this business and feedback was almost universally positive, there were, no one...I mean this is flattery in a

way, but no one felt that their time had been wasted, these audit tenders, you know it's quite hard to engage people in the wider business in audit.

**Yes I can imagine**

So to get no, no complaints that any time was wasted and to have no reluctance to give up additional hours, often you know head of [KEY FUNCTIONS], they all had three or four hours of meetings with the different firms and not one person fed back to me that they'd felt their time had been wasted.

**Right, did you think there was much difference between the final offer if you like or the propositions that the various firms were putting on the table?**

Ummn, I think, I think there was ummn, some different, you would be...the whole thing was actually a really good advertisement for the professional services firms because all three offers were very good.

**Right**

The difference, the reason for choosing [FIRM A] was because of the team, it was because of ummn [FIRM A AUDIT SENIOR MANAGER] and [FIRM A AUDIT DIRECTOR] and their evident understanding at, on the day of the business issues and their ability to engage the non-execs that were there on the day, they were very, very good and that came out of them being better, in my opinion it came out of them spending more time here and being better

prepared, both [FIRM A LEAD AUDIT PARTNER] and the others and that was evident

**Right**

Ummn, unfortunately the [NON PARTNER MEMBERS OF AUDIT TEAM] at [INCUMBENT FIRM] couldn't be at the meeting for circumstances that were beyond their control and at [FIRM B] they were significantly more lightweight than [FIRM A AUDIT DIRECTOR] and [FIRM A AUDIT SENIOR MANAGER]

**Right**

[FIRM A AUDIT DIRECTOR], [FIRM A AUDIT SENIOR MANAGER] and the [FIRM A] IT guy [NAME], they all came across really well and actually we made the selection on the basis of the juniors not the seniors because we know that at partner level in these firms people are going to be pretty good and you're only going to see them now and then so ummn, [FIRM A LEAD AUDIT PARTNER] and [FIRM A LEAD RELATIONSHIP PARTNER] and the equivalents here [FIRM B LEAD AUDIT PARTNER] and [LEAD RELATIONSHIP PARTNER] were fantastic but you'd expect them to be fantastic so it was more about the juniors.

**Right**

It was quite interesting that the risk that and you can feed this back to guys, the risk that your, the guys ran, because we gave them the very specific brief...

[Talking together]

...much material and they just ignored it and that really annoyed me and really annoyed AUDIT COMMITTEE CHAIR but in the end they didn't get penalised for that because the offer was obviously better and the team was better.

### **Right**

So we were annoyed because obviously they ignored the instruction and the other firm [FIRM B], stuck to the brief of writing a very focused response.

### **Was that all they submitted just the....[talking together]**

No, they did, they did submit some other stuff and they did a misguided kind of aside the presentation this thing which is, they're kind of, they're accountants not marketing people and they kind of used analogies to deliver the presentation and it wasn't brilliant. So I mean that type of [laugh] let the records show I'm raising in a picture of a cartoon, a cartoon of a car's journey and the analogy was between IT as an IT business and a Formula One car, of a racing car you know high performance and tuning and everything and it got a bit tiresome and it wasn't, I don't think it's the right way, I actually in my last job I've seen plenty of marketing pictures and the marketing guys can bring in these type of graphical aids and do a really good job but I wouldn't suggest it was the way forward for accountants.

**So was each member of their team some kind of you know...mechanic or**

No (laughter), no but they kept using like motoring analogies and it just wore really thin and it wasn't, you know it wasn't the reason they didn't get it but I don't think it was the greatest invention and the thing that, I mean we were cross about it[FIRM A SUBMITTING A BIGGER DOCUMENT THAN PRESCRIBED], annoyed about it but in the end it didn't really count against [FIRM A] and arguably because there's more detail in here it may have subconsciously actually aided them but it was a tiny bit of a risk that by ignoring the instruction that could have counted, that certainly would have counted if it was closer.

**Yes**

But because it was quite clear that this was the best team

**Right**

The content in here is excellent by the way not really that it wasn't any good it just, it just is a bit too detailed.

**I was going to say was the, was the 8 to 10 pages as good as [FIRM B]'s 8 to 10 pages? Notwithstanding you've got an extra 40 pages on the top...**

[Laughter] it was at least as good but there was some filler in here and there was a very detailed audit plan which was excellent but it's not, we didn't ask for that level of detail and again it's really tricky this because it did really annoy me, it did really annoy [AUDIT COMMITTEE CHAIR] and it, but it didn't cost because it was still so obvious that that was the best offer.

**Right**

As well as the best offer, the best team, the best you know the whole thing so you've got a very good partner, excellent team, really well thought out audit approach and you didn't, I couldn't hand on my heart say excellent team although very good partners, well thought out audit approach and this one here, pretty well thought out audit approach, the team was absent and the team was the same team that has been coming for the last few years, very nice people, no issue with them but they've been following a really daft approach.

**Right**

And we were a bit upset that they hadn't challenged it and I can understand why it's difficult to challenge because they take the partner's lead but we had some reservations that however nice they were and competent they were why did they do far too much work for two years.

**The point about the team is a very interesting one, how people have got in their mind you know, this person was a better, was better than that person.**

Right

**You know was it, what they said, was it how they came across you know, was it...maybe it's not evident maybe it's just you know something you pick up I don't know.**

There's two things right, in the meetings, [AUDIT COMMITTEE CHAIR] asked almost the same questions to both groups, he asked the people at the



more junior end but not that junior, down to [FIRM A AUDIT SENIOR MANAGER]'s level, manager to level to talk about themselves for a minute and it was such an obvious invitation to actually talk about themselves, it wasn't, he wasn't making small talk he wanted to know a bit about them, what their background was, whether they'd been to university, how long they'd been an accountant, what they'd worked on

### **Right**

And [FIRM A AUDIT SENIOR MANAGER] and [FIRM A AUDIT DIRECTOR] answered the question pretty fully. The guys at [FIRM B] misinterpreted the question as some kind of small talk or that we were going to go along the table and get to the real big guys where we wanted to hear about you know their 25 years in [RELEVANT INDUSTRY] which we're not remotely interested in, we know their good it's more about you and they kind of, as quickly as possible got off the topic and that was just a bad misread, that's unfortunate and that shouldn't really, shouldn't have made that much of a difference but it didn't help. So we didn't have the information on this side, we also had on this side a secondee

### **Right**

And some of the non-execs and one or two of our finance team didn't like the fact that they put forward a secondee, I actually disagreed with them completely and said that these firms have loads of secondees you know, they kind of recirculate new blood around the...

**So this was an overseas...**

Yes who was going to leave in a year

**Right**

I said you shouldn't cloud our judgement at all because I think often these secondees can be much better than anyone that they've got locally and it's really about the job they do and they should be able to hand that over after a year.

**Because you don't send people on secondment who are idiots or not...**

No and I, I was the only person who (hesitating) argued against that being a factor but they still didn't like it.

**Right**

So you know they can make up their own minds but they didn't like it that they had a secondee on this side who didn't see the people on this side, on [INCUMBENT FIRM]'s side again and [FIRM A] ones were very good and they came across well and when they're asked particular questions as well they answered them very well because they'd been better prepped.

**Right, in terms of, well you've painted a picture of this decision being very much driven on the day of the presentation in terms of you know the responses people gave and so on...**

Not, not, it's not strictly true because I think when we went into the day, having seen the proposals, even though we were annoyed this was too long, we thought this had the best proposal.

**Right**

The fees were more or less the same, everyone was more impressed with....so what I did was I did a round robin before the day to get feedback from everyone that the auditors had met...

**Specific or did you say who did you think the best was?**

Everyone who saw all three sets of people was asked to give a verdict as to whether they thought; who they thought was the best and why

**Right**

And almost everyone said the people who showed the most understanding were the people from [FIRM A].

**Right**

So I either got back they preferred [FIRM A] or they were indifferent they thought they were all good.

**Right**

So the IT guys, who kicked up the fuss in the first place in the end they actually said they could work with either one of the teams.

**Even [INCUMBENT FIRM]?**

Even [INCUMBENT FIRM] which was a great tribute to the IT guy who came in from [INCUMBENT FIRM] he was excellent. I mean I laughed at [COO] when he told me he could work with [INCUMBENT FIRM] because I never ever thought I'd hear him say it, the IT guy they sent him was really good.

**Right.**

Ummn so we asked so when we came to the decision, the non-execs had kind of been briefed that the general opinion was that [FIRM A] were the, had presented best, so you had come across best in the meetings but they were the people that we imagined it would be easiest to work with and they were the best prepared.

**Right**

Most knowledgeable. That feedback came in not just from the UK but I got feedback from [TWO OVERSEAS OPERATIONS] and so we went into the day thinking that it's kind of theirs to lose on the day but on the day the presentation was better than anyone else's anyway so just, it turned into a decision which was absolutely unanimous.

**And who, who was driving that decision how did you in the end make the decision?**

The decision's for the Audit Committee

**Right**

To recommend to the Board so the decision is here is the response to [AUDIT COMMITTEE CHAIR] who's the expert of the non-execs who has got an accounting background, so it was him, [A SECOND AUDIT COMMITTEE MEMBER] who's one of the other non-execs, [A THIRD AUDIT COMMITTEE MEMBER], they were both there on the day. [AUDIT COMMITTEE CHAIR] was involved more closely in the whole process, the Chief Exec was there but he was really here on the day he wasn't involved in the process, there was myself and the two guys the financial controllers [NAMES DELETED] and [AUDIT COMMITTEE CHAIR], you know I'm not, I think being honest I think he only listens to myself [FINANCIAL CONTROLLERS] what our opinion was. He certainly, [CEO] didn't have a strong view he thought these were better and he hadn't been involved but he was interested, [AUDIT COMMITTEE CHAIR] was interested in what was the poll had said so what the people had said you know what the XX had said our IT guys had said, and he was interested in what the accountants say because they'd spend more time than anyone with the teams and obviously we'd had the opportunity we'd been out for drinks with them, we'd had individual meetings here about particular issues. We'd gone through the accounts with them and we'd had a bit more time so it was particularly interesting what they think because they are, they should be the most knowledgeable about different people's confidences.

## **Right**

So he took all that on board, in the end there was kind of no decision to make because he's asking everyone and they're all saying the same things.

**Right**

He'd have been pretty contrary if he hadn't have...

**I'm just trying to imagine the picture of you've had all the presentations and then you sit down and you know, what happens in that room you know there's [AUDIT COMMITTEE CHAIR] saying OK...**

Well no it really is people just said that was easy wasn't it? And we all said no one even needed to say who was appointed.

**Right**

Ummn, so [AUDIT COMMITTEE CHAIR] says right so it's [FIRM A] and you've got to let the others know and all we did is we wrote down a list of reasons to give the others and feedback to back to give the different firms about....

**How did you get to that "it's obvious...?"**

It just was very obvious I think because, if you think you're leading into it with almost everyone agreeing that they were the best of the pitching firms...

**Yes**

[FIRM A] did a presentation and the best of the pitching firms. It was a pretty obvious thing to appoint. I think we'd gone into the day with mindset down unless these guys really messed up they would end up being an

improvement on [INCUMBENT FIRM] and they would be still ahead of [FIRM B].

**Right. It's erm...**

The strange thing I mean, it's not normal, normally we argue over things it was literally it didn't even kind of need to be said when we went into the other room who...

**You just kind of look at each other...**

Yes, yes that's an easy one! Well we need to get back to the other firms to explain, give them some proper feedback as to why they were unsuccessful and the easy job is letting [FIRM A] know they were successful.

**Right OK. One of the things that you know sometimes plays and it doesn't sound like it played here particularly strongly is people's past track record and relationships you know, I guess you could have come to the table feeling strongly I know the [FIRM B] guys and....**

Yes of course I do yes

**And you know I'm and obviously you didn't...**

Yes, yes, yes

**But others might have....**

Yes I do know them they're really good friends, there were good partners they were going to stick on this job [FIRM B LEAD AUDIT PARTNER] he's a

friend, I still socialise with all the [FIRM B] guys so I know them well, he would have been a great match for me personally because he's an excellent partner but then so is [FIRM A LEAD AUDIT PARTNER].

**Right**

So obviously in my position I've got to be completely impartial, I think you embarrass yourself if you're not these days and I think these days it's very obvious when, if it's a decision with a big group it's pretty obvious if you're evidently favouring one for another.

**Yes**

And I think in this situation the margin was such that you couldn't, no one could even introduce a bias because it would have looked completely irrational

**Right**

So if I'd have said after receiving that presentation, reading the reports and feedback from all the staff my decision is I think [FIRM B] would be the best I think I would have risked really embarrassing myself.

**Right**

So I was very favourable to, ummn, I didn't know all the guys but [FIRM B LEAD AUDIT PARTNER]'s excellent, this is actually a pretty good pitch, the team wasn't as good and they spent I think 60 or 80% less time than the [FIRM A] guys in getting it right.



**Right and I mean did you...had you worked with the [FIRM B] guys on the client side I mean you know across the table with them?**

No

**Right**

We do a bit of tax with them but I know, I just know them from I mean I know [FIRM B LEAD AUDIT PARTNER] from a social group.

**Right, do you think that would have made any difference if they'd had a track record with you?**

With working with us?

**With working with you?**

I think it might have helped yes

**Right**

I mean obviously only if it had been (hesitation) a kind of favourable track record but it might have helped. I don't, I don't think we've had, we didn't have much obviously we had the track record of working with [FIRM A] on tax but increasingly on tax we now use [FIRM C -BIG 4 FIRM WHICH DIDN'T TENDER].

**Right**

So the reason that [FIRM C] didn't pitch for this was because they are the favoured tax adviser at the moment.

## **Right**

Ummn, so no I don't think that would have made a big difference and I was absolutely conscious about not favouring one over another, the only times I stuck up for [FIRM B] was when I thought there's a genuine reason to argue against a point that's made against them which is a bit irrational like having a secondee which I did think is just a silly thing to object to, you're going to expect to get secondees through the audit firms and I don't really see how it's a bad thing.

## **Right and did you leave FIRM C out, was that your choice?**

Was our choice.

## **Chose to leave them out because they were...**

We chose to leave them out because we'd done a lot of our tax planning through them and will continue to do the tax planning through all of these firms but we've currently used them most or had been using them the most and we thought three was enough when we went to pitch.

## **Right, never thought about bringing a mid tier firm in?**

We did yes but we, you kind of quickly abandon it off when you think about the global aspect of it, probably would do a good job but when you say I want to come and speak to your person in [TERRITORIES IN ASIA PACIFIC] it falls down. I mean I guess why those mid-tier have issues they do breaking through.

**Yes do you know them at all?**

We don't, no. [AUDIT COMMITTEE CHAIR]'s son actually works for one, there's no prejudice against them

**Right**

It's just that when we talked about it he kind of dismissed it, just said look I can't, I can't see it, I can't see them having the breadth.

**Right**

Internationally.

**Didn't worry about reputation or brand issues?**

Probably there's that as well but he didn't say it.

**Right**

I think that would exist, it would have been pretty hard to have got rid of [INCUMBENT FIRM] and appointed [MID TIER FIRM] or, those firms are quite big firms now but certainly to go would look really odd.

**OK.**

But no his son works at one of those firms so I can't think he's prejudiced against them, I just think it's just, it's just I think it's just an unfortunate part of business now that you don't, unless it's one of the Big 4 firms it looks like you're trying to hide something.

**Right**

It's deeply perverse.

**Right, just the House of Lords looking into the Big 4 I suppose we're....**

Yes, it's more the, it's definitely more in our case we didn't think it was credible they could provide service, the same quality across all the locations because it's important for us.

**It is a pretty specialist business...**

Absolutely and it's quite hard I mean obviously we've got a little bit of work to be done in [EUROPEAN COUNTRY], some to be done in [THREE ASIAN COUNTRIES] so it needs a really robust, global network so that's why we didn't consider them.

**Right. Just in terms of the feedback that you got from everybody you said that you know that those that did come back [FIRM A] those that didn't said I'm happy with all three, did you did that in a very structured way because I guess it's....**

Most of them we've been working together for such a long time I emailed them or if I could go and see them I just went to see them and just asked them what did they think and you know I didn't, if they just said I thought [FIRM A] were miles the best, the best prepared we kind of left it at that. I didn't prep, probe....

**You didn't say oh why do you say that?**

No, no, no, I just got general feedback from them, in a couple of cases I asked them why so the Head of [one department] is a really sensible chap, I asked him why he thought that [FIRM A LEAD AUDIT PARTNER] had the best understanding and the guys that he'd seen had the best understanding of the business because of [FIRM A LEAD AUDIT PARTNER]'s background with [RELEVANT INDUSTRY SECTOR] and he found the meetings really useful and that the guys understood it, the business straight away so a couple of them I probed a bit deeper but in most cases you know, to be honest what they know about audit and what they think about, what they can remember about three meetings that they've had when they haven't been, they've been engaged but they haven't been making notes or anything. It was more just to get their impression, it's about the people fit and the impression they got and it's that, [Name] thing which is your snap judgement is....probably you know, most of the time that is as good as information you're going to get.

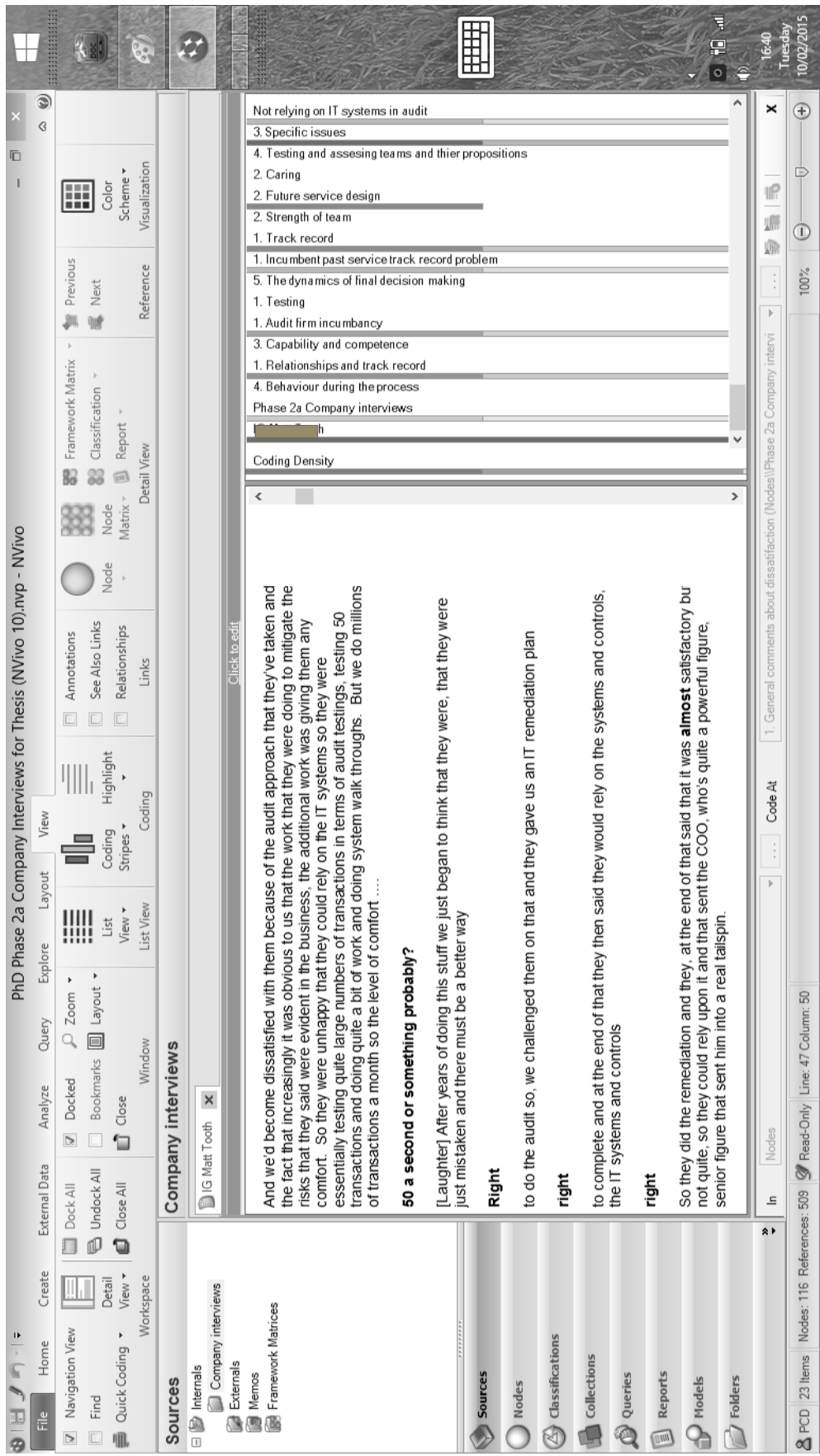
**Right – OK thank you! I think I'm pretty much done. I guess one final question. If you reflect for a moment, do you think there is anything we should have discussed about this tender but haven't?**

....No, I think we've covered everything

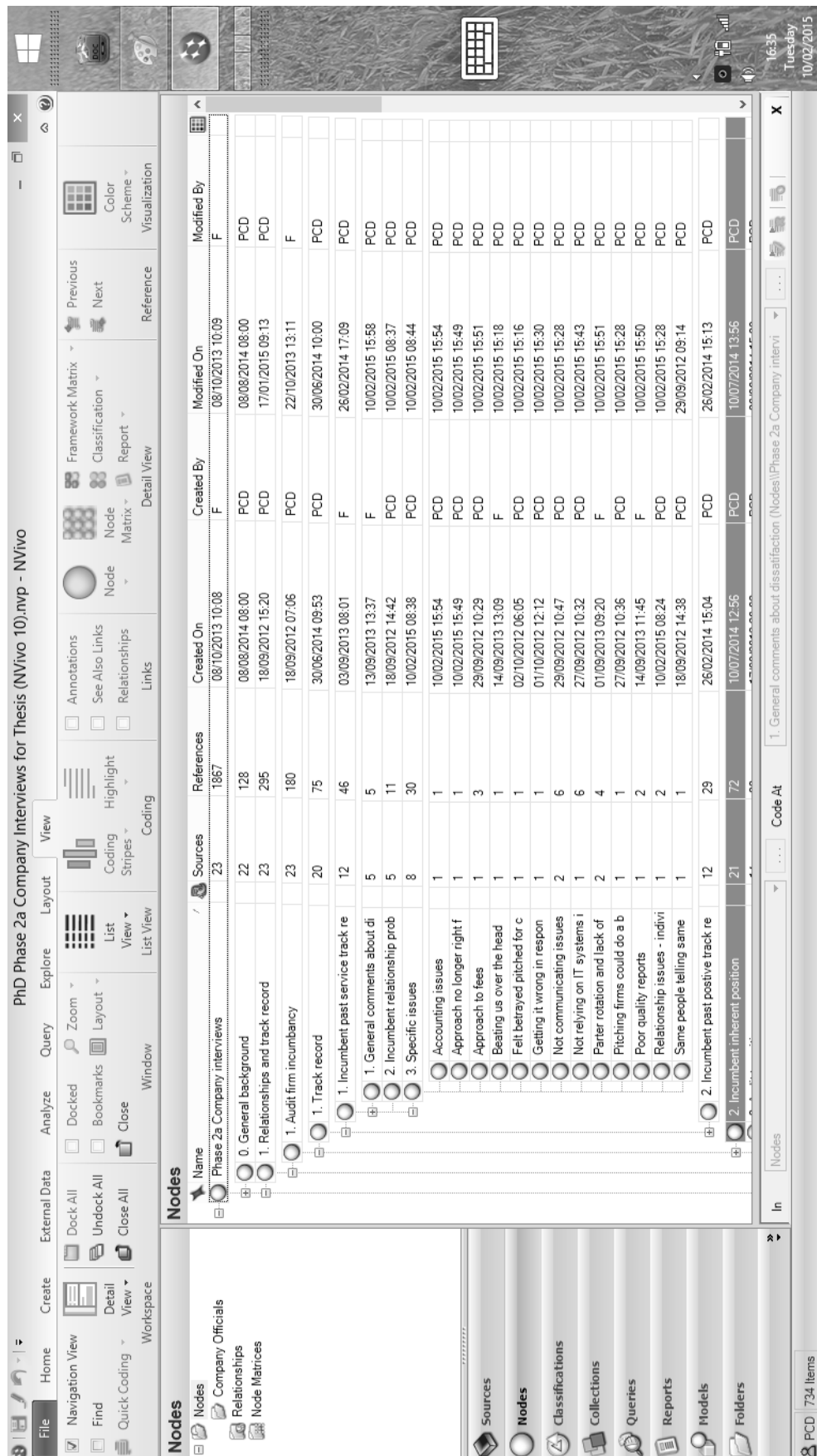
**OK thank you.**

**[TAPE TURNED OFF]**

# APPENDIX V: ILLUSTRATION OF INITIAL CODING



## APPENDIX VI – ILLUSTRATION OF CODING FRAMEWORK



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